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EQUITY MARKETS

| India | Change % | | | |
|--------------------------------|----------|-------|-------|--------|
| | 29-Jul | 1-day | 1-mo | 3-mo |
| Sensex | 17,992 | 0.2 | 1.6 | 2.5 |
| Nifty | 5,409 | 0.2 | 1.8 | 2.5 |
| Global/Regional indices | | | | |
| Dow Jones | 10,467 | (0.3) | 7.1 | (4.9) |
| Nasdaq Composite | 2,252 | (0.6) | 6.8 | (8.5) |
| FTSE | 5,314 | (0.1) | 8.1 | (4.3) |
| Nikkei | 9,564 | (1.4) | 1.9 | (13.5) |
| Hang Seng | 21,094 | 0.0 | 4.8 | (0.1) |
| KOSPI | 1,757 | (0.8) | 3.5 | 0.9 |
| Value traded – India | | | | |
| Cash (NSE+BSE) | 210 | | 162 | 169 |
| Derivatives (NSE) | 1,463 | | 824 | 1,254 |
| Deri. open interest | 1,752 | | 1,147 | 1,428 |

Forex/money market

| | Change, basis points | | | |
|-------------------|----------------------|-------|------|------|
| | 29-Jul | 1-day | 1-mo | 3-mo |
| Rs/US\$ | 46.5 | (24) | 6 | 203 |
| 10yr govt bond, % | 7.8 | 3 | 22 | (30) |

Net investment (US\$m)

| | 28-Jul | MTD | CYTD |
|-----|--------|-------|-------|
| FIs | 140 | 2,461 | 9,161 |
| MFs | (124) | (636) | (282) |

Top movers -3mo basis

| Best performers | Change, % | | | |
|-------------------------|-----------|-------|--------|--------|
| | 29-Jul | 1-day | 1-mo | 3-mo |
| HPCL IN Equity | 432.8 | (1.6) | (7.8) | 37.2 |
| BJAUT IN Equity | 2695.9 | (0.2) | 8.4 | 28.8 |
| APNT IN Equity | 2613.8 | 1.1 | 13.6 | 25.7 |
| BJFIN IN Equity | 431.6 | 1.2 | (1.3) | 25.5 |
| BPCL IN Equity | 638.9 | (0.7) | (3.6) | 23.5 |
| Worst performers | | | | |
| RNR IN Equity | 42.1 | (2.0) | (36.2) | (39.9) |
| ABAN IN Equity | 878.2 | (2.2) | 4.2 | (26.6) |
| FTECH IN Equity | 1194.9 | (3.1) | (10.7) | (23.2) |
| PUNJ IN Equity | 127.7 | (0.9) | (6.2) | (22.8) |
| JPA IN Equity | 118.5 | (0.9) | (7.9) | (19.8) |

JULY 30, 2010

RESULT

Coverage view: **Cautious**

Price (Rs): **1,247**

Target price (Rs): **1,480**

BSE-30: **17,992**

Not DD&A this time. ONGC reported 1QFY11 standalone net income at ₹36.6 bn (-3.1% qoq, -21.1% yoy) versus our estimate of ₹46.4 bn. The weaker-than-expected performance was due to (1) lower crude sales at 5.3 mn tons versus our estimate of 6.1 mn tons and (2) higher subsidy burden at ₹55.2 bn versus our estimate of ₹52.6 bn. We maintain our BUY rating on the stock with a revised target price of ₹1,480 given (1) potential upside of 19% to our target price and (2) several potential triggers.

Company data and valuation summary

Oil & Natural Gas Corporation

Stock data

| | |
|-------------------------------|-----------|
| 52-week range (Rs) (high,low) | 1,347-934 |
| Market Cap. (Rs bn) | 2,666.2 |

Shareholding pattern (%)

| | |
|-----------|------|
| Promoters | 74.1 |
| FII's | 4.2 |
| MFs | 2.2 |

Price performance (%)

| | 1M | 3M | 12M |
|----------------|-------|------|-------|
| Absolute | (4.6) | 19.1 | 13.5 |
| Rel. to BSE-30 | (7.0) | 15.8 | (4.3) |

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|---------|---------|---------|
| EPS (Rs) | 91.4 | 116.6 | 136.1 |
| EPS growth (%) | 1.3 | 27.5 | 16.7 |
| P/E (X) | 13.6 | 10.7 | 9.2 |
| Sales (Rs bn) | 1,090.5 | 1,199.0 | 1,350.0 |
| Net profits (Rs bn) | 195.6 | 249.3 | 291.0 |
| EBITDA (Rs bn) | 498.9 | 549.8 | 642.8 |
| EV/EBITDA (X) | 4.9 | 4.2 | 3.4 |
| ROE (%) | 14.6 | 16.8 | 17.6 |
| Div. Yield (%) | 2.6 | 3.4 | 3.9 |

Lower-than-expected 1QFY11 net income at ₹36.6 bn versus ₹46.4 bn estimate

ONGC reported lower-than-expected 1QFY11 net income (standalone) at ₹36.6 bn (-3.1% qoq, -24.5% yoy) versus our estimate of ₹46.4 bn. ONGC's 1QFY11 EBITDA was at ₹81.9 bn (-13% qoq and -14.4% yoy) versus our estimate of ₹98.6 bn. The negative variance was due to (1) lower-than-expected crude sales at 5.3 mn tons versus our estimate of 6.1 mn tons and (2) higher-than-expected subsidy burden at ₹55.2 bn versus our estimate of 52.6 bn. We note that the DD&A charges were lower at ₹31 bn (-30% qoq and -2% yoy).

High level of inventories result in lower sales; crude production relatively stable

Exhibit 2 gives a breakdown of ONGC's oil production and sales from its domestic fields and joint ventures. ONGC's crude oil sales were lower in 1QFY11 at 5.31 mn tons versus 5.67 mn tons in 4QFY10 and 5.45 mn tons in 1QFY10. However, the crude production volumes were relatively stable at 6.6 mn tons (-0.6% qoq and +0.9% yoy). The management attributed the lower sales to several factors—(1) increase in crude oil inventory by 130,000 tons, (2) filling up of Cairn's pipeline to commence operations, (3) lower oil production from Mumbai High and (4) sale of certain cargoes in early-July which would be booked in the next quarter.

Valuations attractive with 19% potential upside to our 12-month fair valuation of ₹1,480

We find ONGC's valuations attractive with the stock trading at 9.2X FY2012E EPS and 4.6X FY2012E DCF. We maintain our BUY rating on the stock with a revised target price of ₹1,480 based on 10X FY2012E EPS plus value of investments. We see significant upside to our earnings and fair valuation for ONGC in our blue-sky scenario case of (1) full deregulation of auto fuel prices and (2) government bearing 100% of the under-recovery on cooking fuels (see Exhibit 4).

Reduced FY2011-13E EPS estimates by 4-7%; retain BUY

We maintain our BUY rating on ONGC with a revised target price of ₹1,480 (₹1,450 previously). We have revised our FY2011-13E EPS to ₹117 (-6.7%), ₹136 (-3.6%) and ₹159 (-4.2%). The revision to earnings reflects (1) lower volumes (-ve impact), (2) higher share of ONGC in subsidy sharing (-ve impact) and (3) weaker rupee (+ve impact).

QUICK NUMBERS

- 1QFY11 EBITDA at ₹81.9 bn (-13% qoq, -14% yoy)
- Net realized price of US\$54-63/bbl in FY2011-13E versus US\$55.9 in FY2010
- Potential upside of 19% to our target price from current levels

Sanjeev Prasad
sanjeev.prasad@kotak.com
Mumbai: +91-22-6634-1229

Gundeep Singh
gundeep.singh@kotak.com
Mumbai: +91-22-6634-1286

Tarun Lakhota
tarun.lakhota@kotak.com
Mumbai: +91-22-6634-1188

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Key highlights of 1QFY11 results

We discuss key highlights of 1QFY11 results (see Exhibit 1) below.

ONGC standalone interim results, March fiscal year-ends (₹ mn)

| | 1QFY11 | 1QFY11E | 1QFY10 | 4QFY10 | (% chg.) | | | 2011E |
|---------------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|----------------|
| | | | | | 1QFY11E | 1QFY10 | 4QFY10 | |
| Net sales | 138,230 | 161,211 | 149,454 | 160,023 | (14.3) | (7.5) | (13.6) | 679,763 |
| Total expenditure | (56,298) | (62,642) | (53,783) | (65,843) | (10.1) | 4.7 | (14.5) | (249,139) |
| Increase/(decrease) in stock in trade | 923 | | 1,198 | (535) | | | | |
| Raw materials (a) | (1,353) | (1,140) | (1,107) | (1,957) | 18.7 | 22.2 | (30.9) | (4,445) |
| Trading purchase | (43) | — | — | (47) | | | | — |
| Staff expenditure | (2,789) | (2,575) | (2,512) | (2,661) | 8.3 | 11.0 | 4.8 | (11,841) |
| Statutory levies | (28,671) | (33,755) | (30,366) | (28,628) | (15.1) | (5.6) | 0.2 | (133,498) |
| Other expenditure | (24,365) | (25,172) | (20,996) | (32,017) | (3.2) | 16.0 | (23.9) | (99,354) |
| EBITDA | 81,932 | 98,569 | 95,671 | 94,180 | (16.9) | (14.4) | (13.0) | 430,624 |
| Other income | 4,072 | 6,500 | 9,786 | 4,691 | (37.4) | (58.4) | (13.2) | 28,850 |
| Interest | (28) | (269) | (61) | (561) | (89.8) | (54.8) | (95.1) | (269) |
| DD&A | (31,143) | (36,117) | (31,789) | (44,480) | (13.8) | (2.0) | (30.0) | (146,969) |
| Depletion | (12,760) | | (10,090) | (11,610) | | 26.5 | 9.9 | |
| Depreciation | (3,620) | | (2,630) | (3,410) | | 37.6 | 6.2 | |
| Dry wells written off | (8,770) | | (10,680) | (23,810) | | (17.9) | (63.2) | |
| Survey expenses | (5,930) | | (8,430) | (5,860) | | (29.7) | 1.2 | |
| Impairment loss and other adjustments | (50) | | 40 | 210 | | (225.0) | (123.8) | |
| Pretax profits | 54,834 | 68,682 | 73,608 | 53,831 | (20.2) | (25.5) | 1.9 | 312,235 |
| Extraordinary/Prior period adjustment | — | | — | 194 | | | | |
| Tax | (18,256) | (21,600) | (22,905) | (10,288) | (15.5) | (20.3) | 77.5 | (96,140) |
| Deferred tax | 34 | (696) | (2,224) | (5,973) | | | | (2,782) |
| Net income | 36,611 | 46,387 | 48,479 | 37,764 | (21.1) | (24.5) | (3.1) | 213,313 |
| Tax rate (%) | 33.2 | 32.5 | 34.1 | 30.1 | | | | 31.7 |
| Volume data | | | | | | | | |
| Subsidy loss | 55,150 | 52,644 | 4,290 | 49,980 | | 1,185.5 | 10.3 | 151,052 |
| Crude production ex JVs ('000 tons) | 6,050 | | 6,120 | 6,170 | | (1.1) | (1.9) | |
| Crude production - JVs ('000 tons) | 550 | | 430 | 480 | | 27.9 | 14.6 | |
| Gas production ex JVs (mcm) | 5,760 | | 5,750 | 5,640 | | 0.2 | 2.1 | |
| Gas production - JVs (mcm) | 650 | | 640 | 650 | | 1.6 | 0.0 | |
| Crude sales ('000 tons) | 5,310 | 6,074 | 5,450 | 5,670 | | (2.6) | (6.3) | 23,159 |
| Gas sales (mcm) | 5,150 | 5,040 | 5,110 | 5,040 | | 0.8 | 2.2 | 20,400 |
| LPG (000 tons) | 256 | 291 | 258 | 291 | | (0.8) | (12.0) | 1,100 |
| Naphtha/NGL | 435 | 407 | 441 | 403 | | (1.4) | 7.9 | 1,570 |
| C2/C3 | 69 | 135 | 122 | 135 | | (43.4) | (48.9) | 540 |
| SKO | 41 | 42 | 43 | 37 | | (4.7) | 10.8 | 166 |
| Pricing data (US\$/bbl) | | | | | | | | |
| Gross crude price realization | 80.8 | 80.8 | 60.6 | 79.2 | | 33.4 | 2.1 | 75.0 |
| Subsidy discount | 32.8 | 30.1 | 2.3 | 27.7 | | 1,305.6 | 18.1 | 20.6 |
| Net crude price realization | 48.1 | 50.7 | 58.3 | 51.4 | | (17.5) | (6.5) | 54.4 |

Note:

(a) represents consumption of stores & spares.

Source: Company, Kotak Institutional Equities estimates

- Sales volume decline for crude oil and increase for natural gas. 1QFY11 crude sales volume declined 6.3% qoq and 2.6% yoy to 5.3 mn tons versus our estimate of 6.1 mn tons. However, ONGC's crude oil production was relatively stable in 1QFY11 at 6.6 mn tons versus 6.65 mn tons in 4QFY10 and 6.55 mn tons in 1QFY10 (see Exhibit 2). 1QFY11 gas sales volume increased 2.2% qoq and 0.8% yoy to 5.15 bcm in line with our estimate. We highlight that the lower crude sales had an impact of ₹20.6 bn on revenue and ₹15.8 bn on ONGC's EBITDA for 1QFY11 (see Exhibit 3).

Crude oil production remains relatively stable in 1QFY11

Sales volume and production, March fiscal year-ends, 2010-11YTD

| | 1QFY10 | 2QFY10 | 3QFY10 | 4QFY10 | 1QFY11 |
|------------------------------|--------------|--------------|--------------|--------------|--------------|
| Crude oil ('000 tons) | | | | | |
| ONGC production | 6,120 | 6,250 | 6,130 | 6,170 | 6,050 |
| JV production | 430 | 380 | 510 | 480 | 550 |
| Total production | 6,550 | 6,630 | 6,640 | 6,650 | 6,600 |
| ONGC sales | 5,030 | 5,150 | 5,260 | 5,220 | 4,890 |
| JV sales | 420 | 400 | 410 | 450 | 420 |
| Total sales volume | 5,450 | 5,550 | 5,670 | 5,670 | 5,310 |
| Natural gas (mcm) | | | | | |
| ONGC production | 5,750 | 5,850 | 5,870 | 5,640 | 5,760 |
| JV production | 640 | 600 | 600 | 650 | 650 |
| Total production | 6,390 | 6,450 | 6,470 | 6,290 | 6,410 |
| ONGC sales | 4,500 | 4,620 | 4,690 | 4,420 | 4,540 |
| JV sales | 610 | 570 | 560 | 620 | 610 |
| Total sales volume | 5,110 | 5,190 | 5,250 | 5,040 | 5,150 |

Source: Company, Kotak Institutional Equities

Lower crude oil sales impacted ONGC's EBITDA in 1QFY11

Impact of lower crude oil sales on ONGC's revenue and EBITDA, 1QFY11 (₹ bn)

| | |
|--|---------------|
| Reported crude sales volume ('000 tons) | 5,310 |
| KIE estimate of crude sales volume ('000 tons) | 6,074 |
| Difference in reported versus estimate crude sales volumes ('000 tons) | (764) |
| Gross crude price realization (US\$/bbl) | 80.8 |
| Impact of lower crude sales on revenues | (20.6) |
| Cess on crude oil (US\$/bbl) | 7.7 |
| Royalty on crude oil (US\$/bbl) | 9.2 |
| Lifting costs (US\$/bbl) | 1.9 |
| Total direct cash cost (US\$/bbl) | 18.8 |
| EBITDA (US\$/bbl) | 62.0 |
| Impact of lower crude sales on EBITDA | (15.8) |

Source: Company, Kotak Institutional Equities estimates

- ▶ **Net realized price for crude oil.** 1QFY11 net realized crude price was US\$48.1/bbl versus US\$51.4/bbl in 4QFY10 and US\$58.3/bbl in 1QFY10. ONGC's subsidy burden in 1QFY11 was ₹55.2 bn or US\$32.8/bbl in crude price oil equivalent terms versus crude price equivalent of US\$27.7/bbl in 4QFY10 and US\$2.3/bbl in 1QFY10; our estimate was ₹52.6 bn. We note ONGC's share among upstream companies has increased to 82.4% in 1QFY11 versus 81% in FY2010.
- ▶ **DD&A expenses surprised on the upside.** ONGC's DD&A expenses were at ₹31.1 bn (-30% qoq and -2% yoy) versus our estimate of ₹36.1 bn.
- ▶ **Other expenditure increased 16% yoy.** Other expenditure was at ₹24.4 bn (-24% qoq and +16% yoy) versus our estimate of ₹25.2 bn.
- ▶ **Five new discoveries in 1QFY11.** ONGC has made five new discoveries in 1QFY11 and two in July 2010. These include five new prospects and two new pool discoveries.

Several positive catalysts exist

- ▶ **Development of announced discoveries.** We note that ONGC has submitted a viability report to DGH for the approval of the combined development of nine gas finds in the Northern Development Area (NDA) of the deep-water block KG-DWN-98/2 along with two others, G-4 and GS-29 in the neighboring acreage. We continue to see potential upside emanating from announcement of development on several discoveries announced by ONGC in the past 2-3 years. In particular, we would watch out for (1) gas discovery in KG-DWN-98/2 with current reserve estimates of 3.4 tcf, (2) oil discovery in block IG with estimated peak production of 150,000 b/d, (3) discovery in MN-DWN-98/3 and (4) significant oil discovery in KG-DWN-98/2 block.
- ▶ **Weakening rupee.** We see the recent weakening of rupee as positive for ONGC's earnings; a ₹1/ US\$ change will impact ONGC's earnings by about 4% and would increase its FY2011E and FY2012E EPS to ₹122 (+4.3%) and ₹142 (+4%). This will be partly mitigated by a potential increase in subsidy burden for OIL arising from higher gross under-recoveries.
- ▶ **Diesel deregulation.** We expect ONGC to benefit from lower subsidy burden from a potential deregulation of diesel prices. We expect diesel prices to be deregulated by January 2011E as we expect current inflationary concerns to ease by then. We note ONGC's earnings can jump sharply under a benign scenario of full deregulation of regulated products pricing (see Exhibit 4).

ONGC's earnings can jump significantly in a blue sky scenario
EPS estimates, March fiscal year-ends, 2012-13E (₹)

| | 2012E | 2013E |
|-----------------------------|-----------|-----------|
| Base case | 136 | 159 |
| Blue sky scenario (a) | 167 | 195 |
| Potential upside (%) | 23 | 23 |

Note:

(a) Assuming full deregulation of auto fuel and cooking fuels prices.

Source: Kotak Institutional Equities estimates

Key assumptions behind our earnings model

We discuss key assumptions behind our earnings model below. Exhibit 5 gives the major assumptions behind our earnings model and Exhibit 6 gives sensitivity of ONGC's EPS to key variables (rupee-dollar rate, crude oil price, natural gas price).

Strong growth in net realizations over the next few years

Key assumptions, March fiscal year-ends, 2006-14E

| | 2006 | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E | 2014E |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Macro assumptions | | | | | | | | | |
| Rs/US\$ rate | 44.3 | 45.3 | 40.3 | 45.8 | 47.4 | 46.0 | 46.0 | 46.0 | 46.0 |
| Subsidy share scheme loss (Rs bn) | 119.6 | 170.2 | 220.0 | 282.3 | 115.5 | 151.1 | 109.9 | 126.3 | 129.6 |
| Import tariff on crude oil (%) | 5.1 | 5.1 | 5.2 | 0.9 | 0.4 | 5.2 | 5.2 | 5.2 | 5.2 |
| Pricing and volumes assumptions | | | | | | | | | |
| Crude price | | | | | | | | | |
| Crude price, Bonny Light (US\$/bbl) | 57.2 | 64.8 | 78.9 | 83.0 | 67.1 | 75.0 | 75.0 | 80.0 | 80.0 |
| Net crude price, ONGC-India (US\$/bbl) | 43.8 | 46.1 | 54.2 | 51.2 | 55.9 | 54.4 | 60.3 | 63.3 | 62.8 |
| Natural gas price | | | | | | | | | |
| Ceiling natural gas price, India (Rs/cu m) | 3.52 | 3.20 | 3.20 | 3.20 | 3.20 | 6.78 | 7.50 | 7.50 | 7.50 |
| Ceiling natural gas price, India (US\$/mn BTU) | 2.12 | 1.89 | 2.12 | 1.87 | 1.80 | 3.94 | 4.36 | 4.36 | 4.36 |
| International operations | | | | | | | | | |
| Net natural gas price, OVL-Vietnam (Rs/cu m) | 3.1 | 3.2 | 2.8 | 3.2 | 3.3 | 3.2 | 3.2 | 3.2 | 3.2 |
| Net crude price, OVL-Sudan (Rs/ton) | 8,118 | 9,384 | 10,142 | 12,136 | 10,173 | 11,021 | 11,021 | 11,748 | 11,748 |
| Net crude price, OVL-Russia (Rs/ton) | 8,320 | 9,633 | 10,434 | 12,493 | 10,448 | 11,333 | 11,333 | 12,089 | 12,089 |
| Sales volumes—Domestic fields | | | | | | | | | |
| Crude oil - own fields (mn tons) | 20.7 | 22.6 | 22.3 | 21.2 | 20.4 | 20.1 | 20.6 | 20.8 | 20.8 |
| Crude oil - JV (mn tons) | 1.7 | 1.8 | 1.8 | 1.7 | 1.9 | 3.1 | 4.3 | 5.1 | 5.0 |
| Natural gas - own fields (bcm) | 18.2 | 17.9 | 17.8 | 17.7 | 17.7 | 17.5 | 17.0 | 17.5 | 17.8 |
| Natural gas - JV (bcm) | 2.3 | 2.4 | 2.7 | 2.8 | 2.9 | 2.9 | 2.9 | 2.9 | 2.9 |
| Sales volumes—Overseas fields | | | | | | | | | |
| Crude oil (mn tons) | 4.6 | 5.8 | 6.8 | 5.8 | 4.7 | 4.6 | 5.1 | 5.3 | 5.3 |
| Natural gas (bcm) | 1.8 | 2.1 | 2.0 | 2.2 | 2.9 | 3.0 | 3.0 | 3.0 | 3.0 |
| Total sales | | | | | | | | | |
| Crude oil (mn tons) | 25.3 | 28.4 | 29.1 | 27.0 | 25.1 | 24.7 | 25.7 | 26.1 | 26.1 |
| Natural gas (bcm) | 20.0 | 20.1 | 19.7 | 19.9 | 20.6 | 20.5 | 20.0 | 20.5 | 20.8 |
| Total sales (mn toe) | 43.1 | 46.3 | 46.7 | 44.8 | 43.4 | 43.0 | 43.6 | 44.5 | 44.7 |
| Total sales (mn boe) | 315 | 338 | 341 | 327 | 317 | 314 | 318 | 325 | 326 |
| Crude oil (%) | 59 | 61 | 62 | 60 | 58 | 57 | 59 | 59 | 58 |
| Natural gas (%) | 41 | 39 | 38 | 40 | 42 | 43 | 41 | 41 | 42 |

Source: Company, Kotak Institutional Equities estimates

ONGC's earnings are highly sensitive to crude price and exchange rate assumptions

Earnings sensitivity of ONGC to key variables

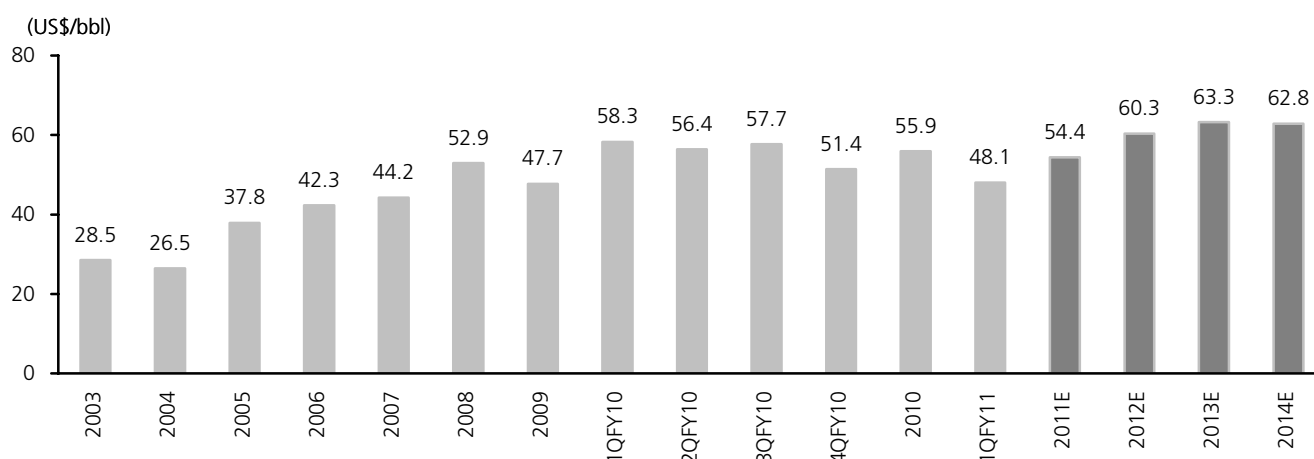
| | 2011E | | | 2012E | | | 2013E | | |
|---------------------------------|--------------|-----------|------------|--------------|-----------|------------|--------------|-----------|------------|
| | Downside | Base case | Upside | Downside | Base case | Upside | Downside | Base case | Upside |
| Exchange rate | | | | | | | | | |
| Rs/US\$ | 45.0 | 46.0 | 47.0 | 45.0 | 46.0 | 47.0 | 45.0 | 46.0 | 47.0 |
| Net profits (Rs mn) | 238,537 | 249,295 | 260,052 | 279,505 | 291,043 | 302,581 | 327,699 | 340,379 | 353,058 |
| Earnings per share (Rs) | 111.5 | 116.6 | 121.6 | 130.7 | 136.1 | 141.5 | 153.2 | 159.1 | 165.1 |
| % upside/(downside) | (4.3) | | 4.3 | (4.0) | | 4.0 | (3.7) | | 3.7 |
| Average crude prices | | | | | | | | | |
| Crude price (US\$/bbl) | 73.0 | 75.0 | 77.0 | 73.0 | 75.0 | 77.0 | 78.0 | 80.0 | 82.0 |
| Net profits (Rs mn) | 236,611 | 249,295 | 261,979 | 277,381 | 291,043 | 304,707 | 326,236 | 340,379 | 354,523 |
| Earnings per share (Rs) | 110.6 | 116.6 | 122.5 | 129.7 | 136.1 | 142.5 | 152.5 | 159.1 | 165.8 |
| % upside/(downside) | (5.1) | | 5.1 | (4.7) | | 4.7 | (4.2) | | 4.2 |
| Cess | | | | | | | | | |
| Cess on domestic crude (Rs/ton) | 3,090 | 2,575 | 2,060 | 3,090 | 2,575 | 2,060 | 3,090 | 2,575 | 2,060 |
| Net profits (Rs mn) | 242,240 | 249,295 | 256,349 | 283,701 | 291,043 | 298,385 | 332,855 | 340,379 | 347,903 |
| Earnings per share (Rs) | 113.3 | 116.6 | 119.9 | 132.6 | 136.1 | 139.5 | 155.6 | 159.1 | 162.7 |
| % upside/(downside) | (2.8) | | 2.8 | (2.5) | | 2.5 | (2.2) | | 2.2 |

Source: Kotak Institutional Equities estimates

- ▶ **Subsidy amount.** We model subsidy amount for FY2011E, FY2012E and FY2013E at ₹151 bn, ₹110 bn and ₹126 bn. We assume upstream companies will bear one-third of total under-recoveries. This is in line with the subsidy sharing of upstream companies in 1QFY11 and the petroleum secretary's recent statement to the same effect. We note that share of upstream companies has been 29-31% in the last three years.
- ▶ **Crude oil price assumption.** We maintain our FY2011E, FY2012E and FY2013E crude oil (Dated Brent) price assumptions at US\$75/bbl, US\$75/bbl and US\$80/bbl. However, we would focus more on ONGC's net realized crude price and our long-term crude price assumption. Exhibit 7 gives ONGC's historical net realized price and our expectations for FY2011E (US\$54.4/bbl), FY2012E (US\$60.3/bbl) and FY2013E (US\$63.3/bbl).

ONGC's net realization has increased steadily over the past few years

ONGC's net crude price realization, March fiscal year-ends, 2003-2014E (US\$/bbl)



Source: Company, Kotak Institutional Equities estimates

- ▶ **Natural gas price assumption.** We assume FY2011E, FY2012E and FY2013E natural gas price at ₹6.8/cu m, ₹7.5/cu m and ₹7.5/cu m to reflect the government's decision to increase the price of APM gas in May 2010.

- ▶ **Exchange rate assumption.** We now model exchange rate for FY2011E, FY2012E and FY2013E at ₹46/US\$, ₹46/US\$ and ₹46/US\$ versus ₹45/US\$, ₹45.3/US\$ and ₹45.3/US\$ earlier.

MRPL 1QFY11 results—weak refining performance coupled with forex loss

MRPL, ONGC's 71.6% refining subsidiary, reported 1QFY11 net income of ₹285 mn compared to ₹2.5 bn in 4QFY10 and ₹4.2 bn in 1QFY10. The steep decline in net income qoq and yoy reflects (1) lower refining margins at US\$1.9/bbl (-US\$3.3/bbl qoq and -US\$6.1/bbl yoy), (2) foreign exchange loss of ₹1.5 bn in 1QFY11 versus foreign exchange gain of ₹1.7 bn in 4QFY10 and ₹651 mn in 1QFY10 and (3) adventitious loss of US\$0.9/bbl in 1QFY11 versus adventitious gains of US\$0.3/bbl in 4QFY10 and US\$4.5/bbl in 1QFY10.

MRPL reported refining margin of US\$1.9/bbl in 1QFY11 versus US\$5.3/bbl in 4QFY10 and US\$8/bbl in 1QFY10. MRPL's crude throughput for 1QFY11 was at 2.91 mn tons versus 3.06 mn tons in 4QFY10 and 2.85 mn tons in 1QFY10.

We model FY2011E and FY2012E EPS at ₹2.9 (₹5.2 bn net income) and ₹5.5 (₹9.6 bn net income). We model FY2011E and FY2012E refining margin at US\$3.9/bbl and US\$5/bbl versus US\$5.5/bbl in FY2010 (including adventitious gains of US\$1.9/bbl); all figures include adventitious gains/losses.

We model crude throughput at 12.5 mn tons for FY2011E and 13.5 mn tons for FY2012E. We note that MRPL is undertaking a refinery expansion project to increase capacity to 15 mtpa (versus 12.69 mtpa currently), which is scheduled to be completed by October 2011 at a cost of ₹124 bn. However, we do not rule out delays in the project given that the company is facing issues with respect to land acquisition. We highlight that the company is planning a maintenance turnaround in August 2010.

Consolidated profit model, balance sheet, cash model of ONGC, March fiscal year-ends, 2006-14E (₹ mn)

| | 2006 | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E | 2014E |
|--|----------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| Profit model (Rs mn) | | | | | | | | | |
| Net sales | 807,603 | 966,542 | 1,091,644 | 1,200,176 | 1,090,473 | 1,198,966 | 1,350,041 | 1,503,920 | 1,531,901 |
| EBITDA | 310,054 | 357,707 | 407,481 | 418,299 | 468,954 | 517,935 | 596,860 | 646,047 | 640,027 |
| Other income | 27,350 | 45,378 | 53,565 | 56,197 | 29,934 | 31,902 | 45,918 | 61,451 | 75,437 |
| Interest | (537) | 394 | (12,027) | (11,442) | (6,212) | (1,376) | (250) | (1,862) | (6,576) |
| Depreciation and depletion | (97,726) | (119,550) | (138,624) | (153,985) | (186,996) | (180,328) | (216,253) | (212,809) | (208,296) |
| Pretax profits | 239,141 | 283,928 | 310,395 | 309,069 | 305,680 | 368,133 | 426,275 | 492,827 | 500,592 |
| Tax | (71,196) | (88,986) | (102,908) | (111,333) | (94,961) | (115,247) | (135,071) | (146,045) | (146,551) |
| Deferred tax | (13,612) | (9,264) | (6,471) | (3,495) | (12,077) | (2,128) | 2,553 | (3,899) | (6,425) |
| Net profits | 154,596 | 178,119 | 202,767 | 200,063 | 198,832 | 250,758 | 293,756 | 342,883 | 347,616 |
| Net profits after minority interests | 153,542 | 176,627 | 199,156 | 196,679 | 195,675 | 249,295 | 291,043 | 340,379 | 346,297 |
| Earnings per share (Rs) | 71.8 | 82.6 | 93.1 | 92.0 | 91.5 | 116.6 | 136.1 | 159.1 | 161.9 |
| | | | | | 91.5 | 124.9 | 141.1 | 166.1 | 171.6 |
| Balance sheet (Rs mn) | | | | | | | | | |
| Total equity | 578,830 | 670,137 | 786,657 | 929,353 | 1,045,186 | 1,190,054 | 1,361,984 | 1,560,756 | 1,760,194 |
| Deferred tax liability | 71,557 | 80,976 | 87,227 | 92,076 | 104,153 | 106,281 | 103,728 | 107,627 | 114,052 |
| Liability for abandonment cost | 128,675 | 151,857 | 129,325 | 171,451 | 175,368 | 175,368 | 175,368 | 175,368 | 175,368 |
| Total borrowings | 28,767 | 21,826 | 22,039 | 73,633 | 57,256 | 37,724 | 83,124 | 119,024 | 106,924 |
| Current liabilities | 142,435 | 187,051 | 251,797 | 293,480 | 237,041 | 240,486 | 258,101 | 282,965 | 292,892 |
| Total liabilities and equity | 950,264 | 1,111,847 | 1,277,045 | 1,559,994 | 1,619,004 | 1,749,913 | 1,982,305 | 2,245,740 | 2,449,430 |
| Cash | 90,743 | 206,262 | 249,807 | 224,671 | 212,010 | 327,510 | 545,796 | 791,568 | 1,034,631 |
| Current assets | 240,210 | 192,652 | 257,384 | 309,494 | 295,048 | 327,444 | 347,186 | 371,718 | 381,194 |
| Total fixed assets | 565,722 | 643,219 | 695,227 | 871,287 | 950,589 | 928,661 | 923,026 | 916,157 | 867,306 |
| Goodwill | 14,172 | 27,686 | 22,847 | 111,108 | 111,108 | 111,108 | 111,108 | 111,108 | 111,108 |
| Investments | 35,753 | 36,888 | 45,041 | 36,926 | 43,744 | 48,684 | 48,684 | 48,684 | 48,684 |
| Deferred expenditure | 3,663 | 5,141 | 6,739 | 6,506 | 6,506 | 6,506 | 6,506 | 6,506 | 6,506 |
| Total assets | 950,264 | 1,111,848 | 1,277,045 | 1,559,994 | 1,619,005 | 1,749,914 | 1,982,306 | 2,245,740 | 2,449,430 |
| Free cash flow (Rs mn) | | | | | | | | | |
| Operating cash flow, excl. working capital | 216,736 | 252,772 | 284,517 | 274,321 | 262,045 | 311,179 | 369,360 | 400,609 | 393,393 |
| Working capital changes | 46,461 | (4,990) | (24,929) | (109,306) | (41,073) | 21,049 | 57,873 | 33,397 | 450 |
| Capital expenditure | (113,738) | (135,049) | (166,427) | (208,137) | (154,415) | (68,267) | (118,438) | (108,409) | (65,938) |
| Investments | (28,912) | 53,822 | (7,348) | (92,159) | (6,817) | — | — | — | — |
| Other income | 14,537 | 20,422 | 22,822 | 31,612 | 29,934 | 31,902 | 45,918 | 61,451 | 75,437 |
| Free cash flow | 135,083 | 186,976 | 108,636 | (103,668) | 89,674 | 295,863 | 354,712 | 387,048 | 403,342 |
| Ratios (%) | | | | | | | | | |
| Debt/equity | 5.0 | 3.3 | 2.8 | 7.9 | 5.5 | 3.2 | 6.1 | 7.6 | 6.1 |
| Net debt/equity | (10.7) | (27.5) | (29.0) | (16.3) | (14.8) | (24.4) | (34.0) | (43.1) | (52.7) |
| RoAE | 25.9 | 25.5 | 24.8 | 21.0 | 18.3 | 20.7 | 21.4 | 22.0 | 19.8 |
| RoACE | 22.0 | 22.0 | 21.9 | 18.3 | 16.1 | 18.0 | 18.9 | 19.8 | 18.1 |
| Key assumptions | | | | | | | | | |
| Rs/dollar rate | 44.3 | 45.3 | 40.3 | 45.8 | 47.4 | 46.0 | 46.0 | 46.0 | 46.0 |
| Crude fob price (US\$/bbl) | 57.2 | 64.8 | 78.9 | 83.0 | 67.1 | 75.0 | 75.0 | 80.0 | 80.0 |
| Ceiling/actual natural gas price (Rs/000 cm) | 3,515 | 3,200 | 3,200 | 3,200 | 3,200 | 6,783 | 7,500 | 7,500 | 7,500 |
| Subsidy loss (Rs bn) | 119.6 | 170.2 | 220.0 | 282.3 | 115.5 | 151.1 | 109.9 | 126.3 | 129.6 |

Source: Company, Kotak Institutional Equities estimates

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RESULT

Coverage view: **Cautious**

Price (Rs): **1,874**

Target price (Rs): **1,800**

BSE-30: **17,992**

Conditions behind 1QFY11 miss could recur. Hero Honda's 1QFY11 earnings disappointed on higher commodity and emission costs. A decline in commodity prices since and price increases taken by the company should result in margin improvement starting 2QFY11E. We have modeled a 150-200 bps sequential increase in margins from 1QFY11 levels for the remainder of the year. However, an aged line-up in the face of competitive pressures, we believe, limits pricing power and keeps us at a SELL.

Company data and valuation summary

Hero Honda

Stock data

| | |
|-------------------------------|-------------|
| 52-week range (Rs) (high,low) | 2,075-1,292 |
| Market Cap. (Rs bn) | 374.3 |

Shareholding pattern (%)

| | |
|-----------|------|
| Promoters | 55.0 |
| FIs | 30.0 |
| MFs | 2.1 |

Price performance (%)

| | 1M | 3M | 12M |
|----------------|--------|-------|------|
| Absolute | (8.5) | (2.1) | 19.0 |
| Rel. to BSE-30 | (10.0) | (4.5) | 1.7 |

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|-------|-------|-------|
| EPS (Rs) | 111.8 | 115.2 | 130.0 |
| EPS growth (%) | 74.1 | 3.1 | 12.9 |
| P/E (X) | 16.8 | 16.3 | 14.4 |
| Sales (Rs bn) | 157.6 | 185.0 | 207.8 |
| Net profits (Rs bn) | 22.3 | 23.0 | 26.0 |
| EBITDA (Rs bn) | 26.6 | 26.8 | 29.9 |
| EV/EBITDA (X) | 12.2 | 12.2 | 10.4 |
| ROE (%) | 59.1 | 52.4 | 42.8 |
| Div. Yield (%) | 1.6 | 1.6 | 1.9 |

Hero Honda disappoints on higher raw material and emission-related costs

Hero Honda reported PAT of Rs4.9 bn versus our estimate of Rs5.5 bn. EBITDA for the quarter came in at Rs6 bn versus our estimate of Rs7 bn. The Rs1 bn EBITDA miss was partially offset by higher-than-expected financial income. EBITDA margins for the quarter came in at 14% versus our 16.2% estimate. Margins were down 300 bps yoy and 330 bps qoq, primarily driven by higher commodity costs and emission equipment costs that were not fully passed on. Raw material costs as a percentage of sales were at 71.7% versus 67.6% in 4QFY10. 150 bps of the increase was driven by higher costs for emission equipment while the rest can be attributed to higher commodity prices.

Margins expected to increase in 2QFY11E on commodity cost declines and price increases

Hero Honda took price increases in the Rs500-1,000 range in June, the full impact of which will be reflected in 2QFY11E. Additionally, spot commodity prices have declined since April and Hero Honda should see benefits of these as it primarily buys raw materials on a spot basis. We expect margins to bounce back to 15% range in 2QFY11E.

Cutting EPS estimates to Rs115 and Rs130 for FY2011E and FY2012E

We are reducing our FY2011E EPS to Rs115 from Rs121 prior to reflect the 1QFY11 miss of Rs3 and lower margins going forward. We reduced our margin estimate for FY2011E to 15.1% from 16.5% prior. Partly offsetting the margin decline are a lower tax rate and higher other income. We are maintaining our volume estimate of 5.3 mn for FY2011E, implying 15% growth yoy. Our FY2012E EPS goes to Rs130 from Rs136 and is based on 12.5% volume growth and flat margins.

Maintaining Rs1,800 target and SELL rating

Our Rs1,800 target reflects 14X our FY2012E EPS estimate of Rs130. We expect competitive pressures to continue to build up and restrict Hero Honda's pricing power. We have modeled a strong 150-200 bps of sequential uptick in margins for the rest of the year on lower commodity prices and ability to maintain prices. The latter, we believe, is predicated on maintenance of current strong industry volume momentum. We are maintaining our SELL rating on these concerns.

Jairam Nathan CFA
 jairam.nathan@kotak.com
 Mumbai: +91-22-6634-1327

Kotak Institutional Equities Research
 kotak.research@kotak.com
 Mumbai: +91-22-6634-1100

Interim results of Hero Honda , March fiscal year-ends (Rs mn)

| | 1QFY11 | 1QFY11E | 1QFY10 | 4QFY10 | (% chg.) | | | 2010 | 2011E | (% chg) |
|---|---------------|---------------|---------------|---------------|---------------|--------------|---------------|----------------|----------------|-------------|
| | | | | | 1QFY11E | 1QFY10 | 4QFY10 | | | |
| Net sales | 42,966 | 43,077 | 38,224 | 41,223 | (0.3) | 12.4 | 4.2 | 158,605 | 186,295 | 17.5 |
| Total expenditure | (36,941) | (36,116) | (31,723) | (34,106) | 2.3 | 16.4 | 8.3 | (130,936) | (158,189) | 20.8 |
| Inc/(Dec) in stock | 255 | (100) | (124) | 110 | (354.5) | (304.7) | 131.8 | (60) | 213 | (458.5) |
| Raw materials | (30,848) | (29,416) | (25,773) | (27,794) | 4.9 | 19.7 | 11.0 | (107,304) | (131,475) | 22.5 |
| Staff cost | (1,450) | (1,500) | (1,385) | (1,460) | (3.3) | 4.7 | (0.7) | (5,603) | (6,164) | 10.0 |
| Other expenditure | (4,897) | (5,100) | (4,441) | (4,962) | (4.0) | 10.3 | (1.3) | (17,969) | (20,764) | 15.6 |
| EBITDA | 6,025 | 6,961 | 6,501 | 7,117 | (13.4) | (7.3) | (15.3) | 27,670 | 28,106 | 1.6 |
| EBITDA margin (%) | 14.0 | 16.2 | 17.0 | 17.3 | | | | 17.4 | 15.1 | |
| Other income | 534 | 400 | 425 | 695 | 33.6 | 25.8 | (23.1) | 2,356 | 2,429 | 3.1 |
| Interest | 27 | 45 | 55 | 45 | (40.9) | (51.3) | (40.5) | 206 | 185 | (10.2) |
| Depreciation | (483) | (500) | (456) | (487) | (3.4) | 5.9 | (0.8) | (1,915) | (2,123) | 10.9 |
| Pretax profits | 6,103 | 6,906 | 6,525 | 7,370 | (11.6) | (6.5) | (17.2) | 28,317 | 28,597 | 1.0 |
| Extraordinaries | — | — | — | — | — | — | — | — | — | — |
| Tax | (1,187) | (1,381) | (1,524) | (1,382) | (14.1) | (22.1) | (14.2) | (5,999) | (5,576) | (7.0) |
| Net income | 4,917 | 5,525 | 5,001 | 5,988 | (11.0) | (1.7) | (17.9) | 22,318 | 23,020 | 3.1 |
| Adjusted profits | 4,917 | 5,525 | 5,001 | 5,988 | (11.0) | (1.7) | (17.9) | 22,318 | 23,020 | 3.1 |
| Income tax rate (%) | 19.4 | 20.0 | 23.4 | 18.8 | | | | 21.2 | 19.5 | (8.0) |
| Ratios | | | | | | | | | | |
| RM to sales (%) | 71.7 | 69.0 | 68.0 | 67.6 | | | | 68.1 | 70.9 | 4.1 |
| EBITDA margin (%) | 14.0 | 16.2 | 17.0 | 17.3 | | | | 17.4 | 15.1 | (13.5) |
| Net profit margin (%) | 11.5 | 12.9 | 13.1 | 14.6 | | | | 14.2 | 12.4 | (12.2) |
| ETR (%) | 19.4 | 20.0 | 23.4 | 18.8 | | | | 21.2 | 19.5 | (8.0) |
| EPS (Rs) | 24.6 | 27.7 | 25.0 | 30.0 | | | | 111.8 | 115.3 | 3.1 |
| Other details | | | | | | | | | | |
| Sales volumes (# vehicles) | 1,234,039 | 1,234,039 | 1,118,987 | 1,186,536 | - | 10.3 | 4.0 | 4,600,130 | 5,305,755 | 15.3 |
| Net sales realisation (Rs/vehicle) | 34,558 | 34,665 | 34,058 | 34,492 | (0.3) | 1.5 | 0.2 | 34,256 | 34,872 | 1.8 |

Source: Company, KIE estimates

Hero Honda, Volume details, March fiscal year-ends, 2007-2012E

| Volumes | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E |
|-------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| Motorcycles | 3,243,832 | 3,232,320 | 3,565,340 | 4,391,874 | 5,066,570 | 5,692,621 |
| Domestic | 3,147,219 | 3,144,101 | 3,487,164 | 4,300,906 | 4,924,537 | 5,416,991 |
| < 125 cc | 3,041,143 | 2,966,329 | 3,302,095 | 4,067,719 | 4,657,538 | 5,123,292 |
| > 125 cc | 106,076 | 177,772 | 185,069 | 233,187 | 266,999 | 293,699 |
| Exports | 96,613 | 88,219 | 78,176 | 90,968 | 142,033 | 275,630 |
| < 125 cc | 93,692 | 80,620 | 69,644 | 82,180 | 131,488 | 262,976 |
| > 125 cc | 2,921 | 7,599 | 8,532 | 8,788 | 10,546 | 12,655 |
| Scooters | 92,921 | 104,822 | 156,210 | 208,249 | 239,184 | 275,062 |
| Domestic | 91,889 | 102,470 | 153,193 | 202,215 | 232,547 | 267,429 |
| Exports | 1,032 | 2,352 | 3,017 | 6,034 | 6,637 | 7,633 |
| Total 2-wheelers | 3,336,753 | 3,337,142 | 3,721,550 | 4,600,122 | 5,305,755 | 5,967,683 |
| Growth (yoy %) | | | | | | |
| Motorcycles | 8.6 | (0.4) | 10.3 | 23.2 | 15.4 | 12.4 |
| Domestic | 8.8 | (0.1) | 10.9 | 23.3 | 14.5 | 10.0 |
| < 125 cc | 8.0 | (2.5) | 11.5 | 23.2 | 14.5 | 10.0 |
| > 125 cc | 37.1 | 67.6 | 11.5 | 26.0 | 14.5 | 10.0 |
| Exports | 4.3 | (8.7) | (11.4) | 16.4 | 56.1 | 94.1 |
| < 125 cc | 10.8 | (14.0) | (13.6) | 18.0 | 60.0 | 100.0 |
| > 125 cc | (63.9) | 160.2 | 12.3 | 3.0 | 20.0 | 20.0 |
| Scooters | 518.9 | 12.8 | 49.0 | 33.3 | 14.9 | 15.0 |
| Domestic | | 11.5 | 49.5 | 32.0 | 15.0 | 15.0 |
| Exports | | 127.9 | 28.3 | 100.0 | 10.0 | 15.0 |
| Total 2-wheelers | 11.2 | 0.0 | 11.5 | 23.6 | 15.3 | 12.5 |

Source: Company, Kotak Institutional Equities estimates

Hero Honda, Profit model, balance sheet and cash flow model, March fiscal year-ends, 2007-2012E (Rs mn)

| | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E |
|---|---------------|---------------|---------------|---------------|---------------|----------------|----------------|
| Profit model (Rs mn) | | | | | | | |
| Net sales | 99,368 | 103,645 | 123,569 | 158,605 | 186,295 | 209,104 | 238,089 |
| EBITDA | 12,099 | 13,821 | 17,475 | 27,670 | 28,106 | 31,180 | 35,201 |
| Other income | 1,530 | 1,527 | 1,830 | 2,356 | 2,429 | 3,042 | 3,925 |
| Interest | 230 | 358 | 317 | 206 | 185 | 210 | 216 |
| Depreciation | (1,398) | (1,603) | (1,807) | (1,915) | (2,123) | (2,368) | (2,621) |
| Profit before tax | 12,461 | 14,103 | 17,815 | 28,317 | 28,597 | 32,064 | 36,720 |
| Current tax | (3,788) | (4,412) | (4,806) | (6,073) | (5,643) | (6,164) | (7,475) |
| Deferred tax | (94) | (12) | (191) | 74 | 67 | 72 | - |
| Net profit | 8,579 | 9,679 | 12,818 | 22,318 | 23,020 | 25,972 | 29,245 |
| Earnings per share (Rs) | 43.0 | 48.5 | 64.2 | 111.8 | 115.3 | 130.1 | 146.4 |
| Balance sheet (Rs mn) | | | | | | | |
| Equity | 24,701 | 29,862 | 38,008 | 34,650 | 50,447 | 68,270 | 88,339 |
| Deferred tax liability | 1,282 | 1,254 | 1,444 | 1,370 | 1,303 | 1,231 | 1,231 |
| Total Borrowings | 1,652 | 1,320 | 785 | 285 | — | — | — |
| Current liabilities | 14,792 | 18,247 | 20,528 | 44,363 | 28,354 | 31,073 | 34,399 |
| Total liabilities | 42,426 | 50,684 | 60,765 | 80,668 | 80,105 | 100,574 | 123,969 |
| Net fixed assets | 13,555 | 15,487 | 16,943 | 17,528 | 18,655 | 19,787 | 20,665 |
| Investments | 19,739 | 25,668 | 33,688 | 33,688 | 43,688 | 58,688 | 73,688 |
| Cash | 358 | 1,311 | 2,196 | 17,504 | 3,457 | 5,908 | 11,023 |
| Other current assets | 8,775 | 8,057 | 7,939 | 12,911 | 15,267 | 17,154 | 19,555 |
| Miscellaneous expenditure | - | 161 | - | - | - | - | - |
| Total assets | 42,426 | 50,684 | 60,765 | 81,630 | 81,066 | 101,536 | 124,931 |
| Free cash flow (Rs mn) | | | | | | | |
| Operating cash flow excl. working capital | 8,842 | 9,833 | 12,605 | 21,596 | 22,463 | 25,015 | 27,726 |
| Working capital changes | (2,224) | 2,612 | 985 | (78) | 87 | (93) | (102) |
| Capital expenditure | (5,152) | (3,739) | (3,135) | (2,500) | (3,250) | (3,500) | (3,500) |
| Free cash flow | 1,467 | 8,706 | 10,455 | 19,018 | 19,300 | 21,422 | 24,124 |
| Ratios | | | | | | | |
| EBITDA margin (%) | 12.2 | 13.3 | 14.1 | 17.4 | 15.1 | 14.9 | 14.8 |
| PAT margin (%) | 8.6 | 9.3 | 10.4 | 14.1 | 12.4 | 12.4 | 12.3 |
| Debt/equity (X) | 0.1 | 0.0 | 0.0 | 0.0 | - | - | - |
| Net debt/equity (X) | (0.7) | (0.8) | (0.9) | (1.4) | (0.9) | (0.9) | (0.9) |
| Book Value (Rs/share) | 130.1 | 155.0 | 197.6 | 180.4 | 259.1 | 348.0 | 448.5 |
| RoAE (%) | 36.3 | 34.0 | 36.4 | 59.1 | 52.5 | 42.8 | 36.8 |
| RoACE (%) | 33.2 | 31.5 | 34.7 | 57.9 | 51.9 | 42.6 | 36.6 |

Source: Company, Kotak Institutional Equities estimates

JULY 29, 2010

RESULT

 Coverage view: **Attractive**

 Price (Rs): **32**

 Target price (Rs): **28**

 BSE-30: **17,992**

Stable earnings though at rich valuations, retain REDUCE. NHPC reported 1QFY11 results with robust generation and stable revenues during the quarter. Although we see sustained earnings growth (CAGR of 18.3% during FY2011-15E) driven by near-doubling of capacities, we believe that NHPC is richly valued at 1.5X FY2012E net worth and see slippages in execution as a key downside risk. We retain our REDUCE rating with a target price of Rs28/share.

Company data and valuation summary

NHPC

Stock data

| | |
|-------------------------------|-------|
| 52-week range (Rs) (high,low) | 42-28 |
| Market Cap. (Rs bn) | 393.6 |

Shareholding pattern (%)

| | |
|-----------|------|
| Promoters | 86.4 |
| FIs | 1.5 |
| MFs | 1.1 |

Price performance (%)

| | 1M | 3M | 12M |
|----------------|-----|-----|-----|
| Absolute | 5.4 | 4.6 | 0.0 |
| Rel. to BSE-30 | 2.8 | 1.7 | 0.0 |

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|------|--------|-------|
| EPS (Rs) | 1.9 | 1.3 | 1.6 |
| EPS growth (%) | 74.9 | (27.5) | 20.6 |
| P/E (X) | 17.3 | 23.8 | 19.8 |
| Sales (Rs bn) | 52.3 | 47.1 | 62.8 |
| Net profits (Rs bn) | 21.8 | 16.5 | 19.9 |
| EBITDA (Rs bn) | 41.3 | 39.2 | 52.4 |
| EV/EBITDA (X) | 12.8 | 13.8 | 10.6 |
| ROE (%) | 9.7 | 6.4 | 7.4 |
| Div. Yield (%) | 1.7 | 1.1 | 1.3 |

Stable revenues from extant operations, higher other income during the quarter

NHPC reported revenues of Rs10.1 bn (18% qoq, -4% yoy) operating profit of Rs8.2 bn (44% qoq, -7% yoy) and net income of Rs5.4 bn (38% qoq, 7% yoy), respectively. Other income during the quarter at Rs2.1 bn (79% qoq) boosted the net income, though the remainder of the results were largely in line with expectations. We note that operational results are not comparable sequentially due to the seasonal nature of the business. NHPC's gross generation in 1QFY11 was 5,689 MU implying an average realization of Rs1.8/kwh and average O&M of 36p/kwh as compared to 1QFY10 when average realization was Rs1.9/kwh and average O&M was 33p/kwh on generation of 5,482 MU. Depreciation increased marginally (8% qoq) from Rs2.4 bn in 4QFY10 to Rs2.6 bn in 1QFY11 likely attributable to commissioning of Sewa II (120 MW) towards the end of the quarter.

Capacity addition to drive earnings growth; Execution delays remain a risk

NHPC plans to increase its capacity from 5,295 MW to 9,797 MW with commissioning of the projects currently under construction. With near doubling of capacities in the next four years, we believe that NHPC's revenues and net income will grow at a CAGR of 18.2% and 18.3%, respectively, during FY2011-15E. We note that NHPC has already incurred a capex of Rs152 bn up to March 2010 out of the total Rs269 bn and recently commissioned Sewa II (120 MW).

However, slippages in execution leading to commissioning delays remain a key risk to our earnings estimate. Most of projects under construction have missed their original commissioning guidance and further delays in commissioning would be detrimental for NHPC's earnings growth. We note that a six-month delay in commissioning for all the projects would impact our valuation by Re1/share and reduce FY2012E EPS to Rs1.47/share from current level of Rs1.62/share.

Retain REDUCE with a target price of Rs28/share

We retain our REDUCE rating with a target price of Rs28/share. Our valuation includes (1) Rs19/share for operational as well as under construction power projects and (2) Rs8/share for cash and cash equivalents.

Murtuza Arsiwalla
murtuza.arsiwalla@kotak.com
Mumbai: +91-22-6634-1125

Shubham Satyarth
shubham.satyarth@kotak.com
Mumbai: +91-22-6634-1320

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

In our view, NHPC is richly valued at a P/B of 1.5X on FY2012E book (our target price implies a P/B of 1.3X) and risk to earnings from delayed project execution will likely keep the stock performance muted in near term.

Exhibit 1: Stable revenues during the quarter
Interim results for NHPC, March fiscal year-ends (Rs bn)

| | 1QFY11 | 1QFY10 | 4QFY10 | (% Chg.) | | FY2010 | FY2011E | (% Chg.) |
|---------------------------------|---------------|---------------|--------------|------------|-----------|---------------|---------------|-------------|
| | | | | 1QFY10 | 4QFY10 | | | |
| Net sales | 10,197 | 10,603 | 8,629 | (4) | 18 | 43,320 | 36,745 | (15) |
| Operating cost | (2,047) | (1,797) | (2,981) | | | (9,997) | (6,843) | |
| EBITDA | 8,150 | 8,805 | 5,648 | (7) | 44 | 33,323 | 29,902 | (10) |
| EBITDA margin (%) | 80 | 83 | 65 | | | 77 | 81 | |
| Other income | 2,190 | 1,001 | 1,222 | | | 5,601 | 5,875 | |
| Interest & finance charges | (1,042) | (1,220) | (1,005) | | | (4,571) | (5,105) | |
| Depreciation | (2,605) | (2,589) | (2,421) | | 8 | (10,333) | (10,999) | |
| PBT | 6,694 | 5,997 | 3,443 | 12 | 94 | 24,021 | 19,674 | (18) |
| Provision for tax (net) | (1,320) | (976) | 458 | | | (3,116) | (5,230) | |
| Net profit | 5,374 | 5,021 | 3,902 | 7 | 38 | 20,905 | 14,444 | (31) |
| EBITDA margin (%) | 80 | 83 | 65 | | | 77 | 81 | |
| Tax rate (%) | 20 | 16 | (13) | | | 13 | 27 | |
| Key operating parameters | | | | | | | | |
| Units generated (bn units) | 5,689 | 5,482 | 2,277 | | | 16,943 | 18,093 | |
| Tariff (Rs/kwh) | 1.79 | 1.93 | 3.79 | | | 2.56 | 2.03 | |
| O&M (Rs/kwh) | 0.36 | 0.33 | 1.31 | | | 0.59 | 0.38 | |

Source: Company, Kotak Institutional Equities estimates

Exhibit 2: Our SOTP-based valuation yields a target price of Rs28/share
SOTP, NHPC (Rs mn, Rs/share)

| | Value (Rs mn) | Value per share (Rs/share) |
|--------------------------------|------------------|-------------------------------|
| SOTP of power projects (Rs mn) | 228,970 | 19 |
| Cash (Rs mn) | 79,392 | 6 |
| Investments (Rs mn) | 12,783 | 1 |
| Loans and advances (Rs mn) | 17,137 | 1 |
| Total value (Rs mn) | 338,282 | 28 |

Source: Kotak Institutional Equities estimates

Exhibit 3: Most of the projects under construction have already missed their original commissioning guidance

Details of NHPC's projects under construction

| | Total capacity (MW) | Design energy (mn units) | COD | | | Project execution cost (Rs bn) |
|--------------------|------------------------|-----------------------------|---------|------------|---------|-----------------------------------|
| | | | Initial | Revised | Assumed | |
| Teesta Low Dam III | 132 | 594 | FY2007 | FY2011 | Feb-11 | 14.1 |
| Teesta Low Dam IV | 160 | 720 | FY2010 | FY2012 | Aug-11 | 13.1 |
| Uri II | 240 | 1,124 | FY2010 | FY2011 | Feb-11 | 15.8 |
| Parbati II | 800 | 3,109 | FY2010 | XIIth plan | Mar-13 | 42.3 |
| Chamera III | 231 | 1,108 | FY2011 | FY012 | Apr-11 | 17.3 |
| Nimmo-Bazgo | 45 | 239 | FY2011 | FY2012 | May-11 | 9.1 |
| Parbati III | 520 | 1,963 | FY2011 | FY2012 | Sep-11 | 21.0 |
| Chutak | 44 | 213 | FY2011 | FY2012 | May-11 | 9.5 |
| Subansiri (Lower) | 2,000 | 7,422 | FY2011 | XIIth plan | Jan-13 | 79.7 |
| Kishanganga | 330 | 1,350 | FY2017 | FY2017 | Jun-16 | 36.4 |
| Total | 4,502 | 17,842 | | | | 258.3 |

Source: CEA, Kotak Institutional Equities

Exhibit 4: Profit model, balance sheet, cash model of NHPC 2008-13E, March fiscal year-ends (Rs mn)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|--|----------------|-----------------|----------------|-----------------|----------------|----------------|
| Profit model | | | | | | |
| Net revenues | 29,726 | 34,767 | 52,273 | 47,100 | 62,822 | 77,852 |
| EBITDA | 22,150 | 23,110 | 41,290 | 39,181 | 52,412 | 65,589 |
| Other income | 4,572 | 5,953 | 6,473 | 6,738 | 8,423 | 8,310 |
| Interest expense | (6,377) | (7,760) | (7,394) | (6,977) | (14,106) | (19,551) |
| Depreciation | (5,455) | (6,441) | (12,827) | (13,647) | (16,085) | (19,704) |
| Pretax profits | 14,890 | 14,863 | 27,542 | 25,295 | 30,644 | 34,644 |
| Tax | (1,896) | (1,552) | (2,245) | (5,107) | (6,179) | (6,982) |
| Deferred taxation | — | — | (2,521) | (1,466) | (2,151) | (2,670) |
| Minority interest | (1,533) | (1,462) | (1,020) | (2,204) | (2,388) | (2,581) |
| Net income | 11,462 | 11,849 | 21,756 | 16,518 | 19,927 | 22,411 |
| Extraordinary items | — | — | — | — | — | — |
| Reported profit | 11,462 | 11,849 | 21,756 | 16,518 | 19,927 | 22,411 |
| Earnings per share (Rs) | 1.0 | 1.1 | 1.9 | 1.3 | 1.6 | 1.8 |
| Balance sheet | | | | | | |
| Paid-up common stock | 111,825 | 111,825 | 123,007 | 123,007 | 123,007 | 123,007 |
| Total shareholders' equity | 189,310 | 197,678 | 251,072 | 262,521 | 276,242 | 291,638 |
| Advance against depreciation (AAD) | 13,033 | 14,245 | 15,398 | 14,238 | 13,078 | 11,918 |
| Minority interest | 13,968 | 14,944 | 15,895 | 18,099 | 20,487 | 23,068 |
| Total borrowings | 128,555 | 149,310 | 163,515 | 203,705 | 216,810 | 208,238 |
| Deferred tax liabilities | — | — | 2,521 | 3,987 | 6,137 | 8,808 |
| Total liabilities and equity | 344,865 | 376,177 | 448,402 | 502,551 | 532,754 | 543,670 |
| Net fixed assets | 236,171 | 238,323 | 225,568 | 248,000 | 293,945 | 349,306 |
| Capital work-in progress | 74,098 | 105,050 | 138,068 | 161,691 | 147,993 | 90,524 |
| Investments | 20,468 | 17,912 | 33,455 | 12,783 | 10,218 | 7,654 |
| Miscellaneous expenses not w/o | 3 | 23 | — | — | — | — |
| Cash | 23,459 | 26,061 | 61,895 | 87,825 | 88,632 | 96,940 |
| Net current assets (incl. cash) | 14,124 | 14,868 | 51,311 | 80,077 | 80,598 | 96,186 |
| Total assets | 344,865 | 376,177 | 448,402 | 502,551 | 532,754 | 543,670 |
| Free cash flow | | | | | | |
| Operating cash flow, excl. working capital | 20,594 | 20,964 | 39,277 | 32,675 | 39,390 | 46,206 |
| Working capital changes | 5,017 | 1,858 | (608) | (2,836) | 286 | (7,279) |
| Capital expenditure | (35,010) | (39,565) | (33,066) | (59,702) | (48,331) | (17,596) |
| Free cash flow | (9,400) | (16,743) | 5,602 | (29,863) | (8,656) | 21,331 |
| Ratios | | | | | | |
| Net debt/equity (%) | 34 | 33 | 26 | 25 | 24 | 22 |
| Return on equity (%) | 6.7 | 6.5 | 10.3 | 6.8 | 7.8 | 8.3 |
| Book value per share (Rs) | 16 | 17 | 20 | 21 | 22 | 23 |
| ROCE (%) | 5.7 | 5.7 | 7.8 | 5.0 | 6.3 | 7.3 |

Source: Company, Kotak Institutional Equities estimates

On track to meet FY2011E guidance. Sales/PAT were higher than our estimate on account of sales of generic Eloxatin/Protonix in US, which have been discontinued. We believe (1) after the strong revenue growth in 1QFY11 and (2) with estimated sales growth of 7% in 9MFY11E, SUNP is on track to achieve revenue growth guidance of 18-20%. We expect SUNP to continue its sales growth momentum in FY2012E. However, at current price, SUNP trades at 28X FY2011E core earnings. Maintain REDUCE with PT of Rs1,685 (20X FY2012E earnings).

Company data and valuation summary

Sun Pharmaceuticals

Stock data

| | |
|-------------------------------|-------------|
| 52-week range (Rs) (high,low) | 1,853-1,117 |
| Market Cap. (Rs bn) | 368.6 |

Shareholding pattern (%)

| | |
|-----------|------|
| Promoters | 63.7 |
| FII's | 20.2 |
| MF's | 2.6 |

Price performance (%)

| | 1M | 3M | 12M |
|----------------|-------|------|------|
| Absolute | 1.3 | 12.1 | 49.9 |
| Rel. to BSE-30 | (1.3) | 9.1 | 26.4 |

| Forecasts/Valuations | 2010 | 2011E | 2012E |
|----------------------|--------|-------|-------|
| EPS (Rs) | 65.2 | 80.0 | 85.1 |
| EPS growth (%) | (25.7) | 22.6 | 6.4 |
| P/E (X) | 27.3 | 22.3 | 20.9 |
| Sales (Rs bn) | 40.8 | 49.1 | 57.5 |
| Net profits (Rs bn) | 13.5 | 16.6 | 17.6 |
| EBITDA (Rs bn) | 15.4 | 18.2 | 19.8 |
| EV/EBITDA (X) | 21.0 | 17.2 | 15.2 |
| ROE (%) | 17.8 | 18.8 | 17.2 |
| Div. Yield (%) | 0.8 | 0.8 | 0.8 |

1QFY11 sales at Rs14.2 bn, 11% above our estimate

Sales were higher than our estimates primarily on account of one-time sales of generic Eloxatin and generic Protonix in US which have been discontinued since June 30 and April 24. India sales grew 17% yoy adjusted from the low base in 1QFY10, in line with our estimate. Formulations sales in ROW were down 20% yoy, according to our estimates.

PAT at Rs5.6 bn, 16% higher than estimate

EBITDA margin at 48% was 200 bps higher due to higher proportion of sales from high-margin products, which will not be repeated in coming quarters. This led to material cost at 24% of sales, lower than our estimate of 28%. Although EBITDA was 22% higher than our estimate, PAT was 16% higher due to lower other income on account of forex losses which offset interest income.

We increase FY2011-12E PAT by 17% and 10%

We believe (1) after the strong revenue growth shown this quarter and (2) with estimated sales growth of 7% in 9MFY11E, SUNP is on track to achieve revenue growth guidance of 18-20%. Despite a significant element of one-time sales in FY2011E on account of three products; we think SUNP will be able to sustain its sales growth momentum in FY2012E on the back of (1) rich ANDA pipeline at 120; best among Indian peers, (2) generic Gemzar, which though will see significant competition with eight players in market, is a high-value drug with branded sales of US\$1.7 bn and (3) US\$50 mn of sales from likely resumption in Caraco supplies from alternate plant.

Maintain REDUCE with PT of Rs1,685 (from Rs1,560)

At current price, SUNP trades at 28X FY2011E and 21X FY2012E core earnings. At our PT, SUNP will trade at 20X FY2012E earnings. We do not factor in sales from Effexor XR, generic Eloxatin and sales from Caraco plant. Catalysts are (1) resolution of Taro deal, (2) resumption of production at Caraco plant, (3) Effexor XR approval and (4) favorable verdict on generic Eloxatin appeal which is yet to be filed by SUNP. Any positive news on the above will lead to an upgrade in our earnings.

REDUCE

JULY 29, 2010

RESULT

Coverage view: **Attractive**

Price (Rs): **1,780**

Target price (Rs): **1,685**

BSE-30: **17,992**

QUICK NUMBERS

- 1QFY11 sales at Rs14.2 bn, 11% above our estimate
- We increase FY2011-12E PAT by 17% and 10%
- Maintain REDUCE with PT of Rs1,685 (from Rs1,560)

Priti Arora
priti.arora@kotak.com
Mumbai: +91-22-6634-1551

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

1QFY11 sales at Rs14.2 bn, 11% above our estimate

Sales were higher than our estimates primarily on account of one-time sales of generic Eloxatin and generic Protonix in US which have been discontinued since June 30 and April 24.

- ▶ India finished dosage sales adjusted for low base of last year grew 17% yoy, in line with our estimate. SUNP launched 10 products in India.
- ▶ US sales at US\$130 mn was higher than our estimate of US\$85 mn due to higher sales of generic Eloxatin. Sales from this product will not continue in the forthcoming quarters.
- ▶ Formulations sales in ROW were down 20% yoy, according to our estimates.

EBITDA margin at 48%, 200 bps higher than our estimate

EBITDA margin at 48% was 200 bps higher due to higher proportion of sales from high-margin products, which will not be repeated in coming quarters. This led to material cost at 24% of sales, lower than our estimate of 28%.

Staff cost at Rs1.2 bn was as per our estimate and flat qoq. We expect this to move up in coming quarters as CPD has recalled some of the employees. Other expenses at Rs2.6 bn was higher than our estimate of Rs2.1 bn, as Caraco recorded additional expenses related to consultation fees pertaining to FDA.

R&D at 4% of sales was Rs560 mn, down yoy; however, it is expected to pick up in coming quarters due to additional filings from SUNP and Caraco.

PAT at Rs5.6 bn, 16% higher than estimate

Although EBITDA was 22% higher than our estimate, PAT was 16% higher due to lower other income on account of forex losses which offset interest income incurred on cash balance of Rs40 bn. Tax rate at 2% was lower than our estimate of 7%.

Interim results- Sun, March fiscal year-ends (Rs mn)

| | 1QFY11 | 1QFY11E | 1QFY10 | 4QFY10 | % change | | |
|-----------------------------|---------------|---------------|--------------|---------------|------------|------------|-----------|
| | | | | | 1QFY11E | 1QFY10 | 4QFY10 |
| Gross revenues | 14,210 | 12,792 | 8,014 | 10,254 | 11 | 77 | 39 |
| Excise duty | 213 | — | 138 | (571) | NM | 54 | NM |
| Net Sales | 13,997 | 12,792 | 7,876 | 10,825 | 9 | 78 | 29 |
| Material cost | 4,100 | 3,582 | 3,039 | 2,430 | 14 | 35 | 69 |
| Stock changes | (744) | — | (847) | 1,004 | NM | NM | NM |
| Staff costs | 1,246 | 1,200 | 1,251 | 1,160 | 4 | (0) | 7 |
| Others | 2,675 | 2,100 | 1,995 | 1,630 | 27 | 34 | 64 |
| R&D | 560 | 850 | 743 | 683 | (34) | (25) | (18) |
| Operating costs | 7,837 | 7,732 | 6,590 | 6,906 | 1 | 19 | 13 |
| EBITDA | 6,160 | 5,060 | 1,286 | 3,918 | 22 | 379 | 57 |
| Depreciation | 402 | 425 | 376 | 419 | (5) | 7 | (4) |
| Other income | 116 | 600 | 603 | 137 | (81) | (81) | (16) |
| PBT | 5,873 | 5,235 | 1,513 | 3,903 | 12 | 288 | 50 |
| Tax | 97 | 366 | 31 | (13) | (74) | 212 | NM |
| PAT before minority | 5,776 | 4,869 | 1,482 | 3,915 | 19 | 290 | 48 |
| Minority interests | 133 | (1) | (156) | (29) | NM | NM | NM |
| PAT for shareholders | 5,643 | 4,870 | 1,638 | 3,944 | 16 | 244 | 43 |
| India | 6,324 | 6,402 | 3,411 | 5,309 | (1) | 85 | 19 |
| API | 335 | 350 | 279 | 170 | (4) | 20 | 97 |
| Finished dosage | 5,984 | 6,052 | 3,129 | 5,136 | (1) | 91 | 17 |
| Others | 4 | — | 4 | 3 | NM | 13 | 48 |
| International | 7,886 | 6,390 | 4,603 | 4,906 | 23 | 71 | 61 |
| API | 1,104 | 1,140 | 1,190 | 996 | (3) | (7) | 11 |
| Finished dosage | 6,782 | 5,250 | 3,404 | 3,911 | 29 | 99 | 73 |
| Caraco | 132 | 137 | 637 | 156 | (3) | (79) | (15) |
| Rest of the world | 854 | 1,396 | 1,064 | 1,381 | (39) | (20) | (38) |
| Sun ANDAs | 5,796 | 3,717 | 1,703 | 2,374 | 56 | 240 | 144 |
| Others | 1 | — | 9 | 39 | NM | (91) | (98) |
| Total | 14,210 | 12,792 | 8,014 | 10,215 | 11 | 77 | 39 |

Source: Kotak Institutional Equities estimates, Company

We increase FY2011-12E PAT by 17% and 10%

- ▶ We expect SUNP to easily achieve its guidance of 18-20% sales growth in FY2011E. SUN grew sales at 77% yoy in 1QFY11 and we expect sales growth of 7% in 9MFY11E. We expect SUN to grow sales despite absence of generic Protonix in remaining three quarters. This is mainly on account of exclusivity of generic Exelon, product approvals for two limited competition drugs received in 1QFY11 and sustained revenue growth in India finished dosage at 18%.
- ▶ SUNP received 7 product approvals in 1QFY11 and we believe two of these are limited competition products – Levitracetam injection (US\$85 mn), Optivar (US\$50 mn) in addition to shared exclusivity sales of generic Exelon starting 2QFY11E (US\$130 mn sales). We expect SUNP to garner revenues of around US\$40 mn of sales in FY2011E from these three products.
- ▶ We expect SUNP to launch generic Gemzar (US\$1.7 bn) in US in May 2011E and expect it to clock annual sales of US\$34 mn (8-generic player market; 10% market share; 80% price erosion).

 ANDA approvals—1QFY11 (US\$ mn)

| Product | Branded sales | Competition | Sales (KIE est) |
|------------------|---------------|------------------------------|-----------------|
| Xanax | | Crowded | |
| Levitracetam Inj | 85 | 2 | 15 |
| Namenda | 1,200 | Not to be launched till 2015 | |
| Wellbutrin SR | 300 | Crowded | |
| Optivar | 50 | 2 | 9 |
| Flomax | | Crowded | |
| Exelon | 65 | FTF | 17 |

Source: Kotak Institutional Equities estimates, Company

 Change in estimates

| | Current estimates | | Old estimates | | % change | |
|---|-------------------|-----------------|-----------------|-----------------|------------|-----------|
| | FY2011E | FY2012E | FY2011E | FY2012E | FY2011E | FY2012E |
| Gross sales | 49,327 | 57,478 | 46,142 | 53,853 | 7 | 7 |
| API | 6,544 | 7,745 | 6,509 | 7,704 | 1 | 1 |
| India finished dosages | 24,183 | 29,019 | 24,251 | 29,101 | (0) | (0) |
| Caraco | 731 | 2,300 | 1,130 | 2,263 | | |
| SUN ANDAs | 6,621 | 10,506 | 5,245 | 6,036 | 26 | 74 |
| Exclusivity sales | 5,393 | — | 2,532 | — | | |
| RoW | 5,855 | 7,907 | 6,476 | 8,750 | (10) | (10) |
| Able Labs, Chattem | — | — | — | — | | |
| Excise duty | (213) | — | — | — | | |
| Net sales | 49,115 | 57,478 | 46,142 | 53,853 | 6 | 7 |
| Materials | (13,900) | (17,753) | (14,262) | (16,587) | (3) | 7 |
| Selling and administration | (6,819) | (7,874) | (6,593) | (7,608) | 3 | 4 |
| Employee cost | (5,046) | (5,803) | (5,000) | (5,750) | 1 | 1 |
| R&D | (3,110) | (4,598) | (3,400) | (4,308) | (9) | 7 |
| Others | (2,456) | (2,874) | (2,307) | (2,693) | 6 | 7 |
| Total expenditure | (31,331) | (38,903) | (31,562) | (36,945) | (1) | 5 |
| EBITDA | 17,784 | 18,575 | 14,580 | 16,908 | 22 | 10 |
| Depreciation and amortisation | (1,827) | (2,000) | (1,850) | (2,000) | (1) | — |
| EBIT | 15,957 | 16,575 | 12,730 | 14,908 | 25 | 11 |
| Other income | 1,616 | 2,400 | 2,400 | 2,400 | (33) | 0 |
| Pretax profits before extra-ordinaries | 17,572 | 18,975 | 15,130 | 17,308 | 16 | 10 |
| Current tax | (918) | (1,328) | (1,060) | (1,212) | (13) | 10 |
| Deferred tax | — | — | — | — | | |
| Reported net profit | 16,654 | 17,647 | 14,071 | 16,096 | 18 | 10 |
| Minority Interest | 96 | 20 | (51) | 20 | (287) | — |
| Reported net profit after minority interests | 16,559 | 17,627 | 14,122 | 16,076 | 17 | 10 |

Source: Kotak Institutional Equities estimates, Company

Normalised EPS

| | FY2009 | FY2010E | FY2011E | FY2012E |
|----------------------------------|-------------|-------------|-------------|-------------|
| EPS (Rs) | | | | |
| Base adding back one-time costs | 58.5 | 48.1 | 57.2 | 79.7 |
| Generic Protonix+Eloxatin+Exelon | 26.9 | 19.3 | 16.2 | — |
| Interest income | 5.7 | 1.2 | 5.5 | 5.4 |
| One-time expenses | (2.4) | (3.7) | — | — |
| Total | 88.7 | 64.9 | 78.9 | 85.1 |
| P/E (X) | | | | |
| Base | | 38.9 | 28.3 | 20.9 |
| Total | | 27.4 | 22.5 | 20.9 |

Source: Kotak Institutional Equities estimates, Company

Maintain REDUCE with PT of Rs1,685 (from Rs1,560)

We believe after the strong revenue growth shown this quarter and with estimated sales growth of 7% in 9MFY11E, SUNP is on track to achieve revenue growth guidance of 18-20%. Despite a significant element of one-time sales in FY2011E on account of three products; we think SUNP will be able to sustain its sales growth momentum in FY2012E on the back of (1) rich ANDA pipeline, and (2) generic Gemzar, which though will see significant competition with eight players in market, is a high-value drug with branded sales of US\$1.7 bn.

We do not factor in sales from Effexor XR, generic Eloxatin and sales from Caraco plant. Catalysts in 2010 are (1) resolution of Taro deal, (2) resolution of manufacturing issues at Caraco, (3) approval of Effexor XR and (4) favorable verdict on generic Eloxatin appeal, which is yet to be filed by SUNP. We believe any positive news on the above will lead to strong upgrade in earnings and re-rating.

Profit and loss statement, March fiscal year-ends, 2007-2012E

| | 2007 | 2008 | 2009 | 2010 | 2011E | 2012E |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Net sales | 21,321 | 33,565 | 42,723 | 40,761 | 49,115 | 57,478 |
| Materials | (5,767) | (7,222) | (8,556) | (10,978) | (13,900) | (17,753) |
| Selling and administration | (2,616) | (3,759) | (5,543) | (6,317) | (6,819) | (7,874) |
| Employee cost | (1,989) | (2,331) | (3,401) | (4,822) | (5,046) | (5,803) |
| R& D | (2,440) | (2,725) | (3,099) | (2,472) | (3,110) | (4,598) |
| Others | (1,785) | (2,017) | (3,484) | (2,810) | (2,456) | (2,874) |
| Total expenditure | (14,597) | (18,054) | (24,084) | (27,400) | (31,331) | (38,903) |
| EBITDA | 6,724 | 15,511 | 18,640 | 13,361 | 17,784 | 18,575 |
| Depreciation and amortisation | (813) | (969) | (1,233) | (1,533) | (1,827) | (2,000) |
| EBIT | 5,910 | 14,543 | 17,407 | 11,828 | 15,957 | 16,575 |
| Net finance cost | (127) | (88) | — | — | — | — |
| Other income | 2,551 | 1,539 | 2,085 | 2,320 | 1,616 | 2,400 |
| Pretax profits before extra-ordinaries | 8,335 | 15,994 | 19,492 | 14,148 | 17,572 | 18,975 |
| Current tax | (91) | (1,288) | (1,192) | (679) | (918) | (1,328) |
| Deferred tax | 158 | 804 | 481 | — | — | — |
| Reported net profit | 8,402 | 15,509 | 18,780 | 13,469 | 16,654 | 17,647 |
| Minority Interests | 559 | 640 | 603 | (41) | 96 | 20 |
| Reported net profit after minority interests | 7,843 | 14,869 | 18,177 | 13,510 | 16,559 | 17,627 |

Source: Kotak Institutional Equities estimates, Company

Balance sheet, cash model, March fiscal year-ends, 2007-2012E

| | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E |
|--|---------------|---------------|---------------|---------------|----------------|----------------|
| Balance sheet | | | | | | |
| Total equity | 27,728 | 49,915 | 70,449 | 81,164 | 94,926 | 109,757 |
| Total debt | 11,144 | 1,436 | 1,789 | 1,789 | 1,789 | 1,789 |
| Current liabilities | 3,046 | 6,373 | 7,198 | 7,021 | 7,421 | 8,022 |
| Minority Interests | 438 | 1,886 | 1,970 | 1,929 | 2,025 | 2,045 |
| Deferred tax liabilities | 895 | 92 | (679) | (679) | (679) | (679) |
| Total equity and liabilities | 43,250 | 59,701 | 80,728 | 91,224 | 105,483 | 120,934 |
| Cash and cash equivalents | 13,802 | 12,389 | 16,690 | 27,653 | 38,518 | 50,835 |
| Current assets | 16,086 | 26,983 | 25,993 | 25,360 | 29,080 | 32,715 |
| Net fixed assets | 9,514 | 10,354 | 14,625 | 14,792 | 14,465 | 13,965 |
| Intangible assets | 697 | 1,729 | 3,253 | 3,253 | 3,253 | 3,253 |
| Capital -WIP | 608 | 686 | 1,571 | 1,571 | 1,571 | 1,571 |
| Investments | 2,543 | 7,560 | 18,595 | 18,595 | 18,595 | 18,595 |
| Total assets | 43,250 | 59,701 | 80,728 | 91,224 | 105,483 | 120,934 |
| Free cash flow | | | | | | |
| Operating cash flow, excl. working capital | 8,134 | 15,198 | 18,841 | 14,749 | 17,344 | 18,531 |
| Working capital | (5,568) | (7,183) | 1,113 | 476 | (3,225) | (3,014) |
| Capital expenditure | (2,103) | (1,787) | (6,401) | (1,700) | (1,500) | (1,500) |
| Investments | 998 | (5,017) | (11,035) | — | — | — |
| Free cash flow | 1,461 | 1,210 | 2,519 | 13,525 | 12,620 | 14,017 |

Source: Kotak Institutional Equities estimates, Company

JULY 29, 2010

RESULT

Coverage view: **Cautious**

Price (Rs): **644**

Target price (Rs): **760**

BSE-30: **17,992**

Cash generation & cost control add to volume momentum. We raised our EPS estimates for M&M by 7% to Rs44 and Rs52 for FY2011E and FY2012E. The increase is largely driven by a lower tax rate and interest expense. We tweaked down our UV volume estimate to reflect the uncertainty regarding US launch. Our 15.2% EBITDA margin estimate for FY2011E could have upside if commodity costs remain soft as we have assumed margins to remain at 1QFY11 levels. Maintaining BUY at Rs760 target.

Company data and valuation summary

Mahindra & Mahindra

| Stock data | | Forecasts/Valuations | | | |
|---------------------------------|---------------|----------------------|-------|-------|-------|
| | | 2010 | 2011E | 2012E | |
| 52-week range (Rs) (high,low) | 658-367 | EPS (Rs) | 33.9 | 44.1 | 51.7 |
| Market Cap. (Rs bn) | 383.4 | EPS growth (%) | 125.8 | 30.1 | 17.3 |
| Shareholding pattern (%) | | P/E (X) | 19.0 | 14.6 | 12.5 |
| Promoters | 26.3 | Sales (Rs bn) | 186.0 | 233.9 | 270.5 |
| FIs | 28.6 | Net profits (Rs bn) | 20.2 | 26.3 | 30.8 |
| MFs | 4.2 | EBITDA (Rs bn) | 29.6 | 35.5 | 41.9 |
| Price performance (%) | | EV/EBITDA (X) | 13.4 | 11.2 | 9.4 |
| Absolute | 1M 3M 12M | ROE (%) | 30.0 | 29.0 | 27.3 |
| Rel. to BSE-30 | 2.8 22.5 51.1 | Div. Yield (%) | 1.4 | 1.4 | 1.5 |
| | 1.1 19.6 29.3 | | | | |

Raising EPS estimates to Rs44 and Rs52 to reflect lower interest expense and tax rate

We raised our FY2011E and FY2012E EPS estimates for M&M to Rs44 and Rs52 from Rs41 and Rs49. The 7% increase for both years is driven by lower tax rate to 23% and 24% for FY2011E and FY2012E from 26.7% prior. We are also now modeling interest income of Rs400 mn compared to interest expense of Rs300 mn prior. On the tax front, increasing share of profits from the Hardwar facility and higher deduction on R&D spending are primarily driving the decline in tax rates to the 22% range. M&M had net debt of only Rs5 bn at the end of 1QFY11, of which Rs14 bn was made up of low-interest foreign currency loans. We expect further reductions in net debt given the free cash flow generation.

Margin upside possible if commodity costs stay at current levels

Our FY2011E EPS estimate of Rs44 is based on 25% volume growth and 15.2% EBITDA margin, implying a 70 bps margin decline from FY2010. For FY2012E, we are modeling a 16% volume growth and 15.5% EBITDA margins. We believe there could be upside to our margin estimates given the decline in commodity prices. M&M's raw material contracts mostly have only three-month durations and costs could come down as these contracts get renegotiated. We have modeled raw material costs at 69% of sales, not significantly different from the 69.6% reported in 1QFY11. Separately, we have modeled labor and other expenses to average 16% of sales for FY2011E compared to 15.5% reported for 1QFY11.

Raising target to Rs760 as we roll over to FY2012E

We are raising our target to Rs760 from Rs680 as we base our valuation on FY2012E. We assign an Rs600 valuation for M&M's standalone business and Rs160 value for the company's stake in public subsidiaries. The Rs600 standalone valuation reflects 12X FY2012E EPS (net of dividend from subsidiaries) of Rs50. Our 12X P/E multiple reflects a 15-20% discount to the 14-15X average multiple auto stocks trade at. We assign a Rs160 per share valuation for M&M's stake in public subsidiaries and is based on a 20% discount to the current market price or KIE targets, whichever is applicable.

Jairam Nathan CFA
 jairam.nathan@kotak.com
 Mumbai: +91-22-6634-1327

Kotak Institutional Equities Research
 kotak.research@kotak.com
 Mumbai: +91-22-6634-1100

Conference call highlights: Industry growth to slow down and component shortage could get sorted out in 3QFY11E

Volumes: M&M management indicated that they expect a 14-15% growth in the passenger vehicle segment and growth would slow down from the torrid pace currently. On the tractor side, M&M management expects industry growth at the 12-13% rate for the rest of the fiscal year.

Products: Management indicated that the Maxximo has been well-accepted and has garnered 24% share in markets where it has been launched. The 15HP tractor Yuvraaj has been launched extensively within Gujarat now and M&M sold close to 600 units of the tractor in the quarter. In the near future the company expects to launch close to 6-7 variants of the Xylo and Maxximo. Additionally, the company is on target to launch an all-new SUV in 1QFY12E.

On the heavy commercial vehicle front, the company is waiting for the order list to aggregate 500 units before delivering the same.

Component shortage: The company is facing shortages primarily in three components - tires, castings and fuel injection equipment. The component shortage has resulted in 7-8% lower production for the quarter. These shortages are expected to be sorted out only in 3QFY11E.

Capex and investments: M&M has a capex budget of Rs45 bn for the FY2011-13E time period. The spend would primarily go towards product development. The company has decided to expand its tractor capacity through a green-field project, most likely in Tamil Nadu. In addition, M&M expects to make Rs25 bn in investments during the FY2011-13E time period. Gross debt at the end of 1QFY11 totaled Rs30 bn and cash totaled Rs25 bn. Debt-equity ratio at the current quarter stood at 0.35:1.

M&M volume details, March fiscal year-ends (2007-2013E)

| Volumes | 2007 | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|----------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Utility vehicles (incl. pickups) | 127,857 | 148,759 | 153,655 | 224,695 | 260,399 | 298,874 | 328,761 |
| LCVs | — | — | — | 12,639 | 65,000 | 91,000 | 104,650 |
| 3-wheelers | 33,718 | 33,926 | 44,806 | 44,785 | 49,264 | 54,190 | 58,254 |
| Automotive segment | 161,575 | 182,685 | 198,461 | 282,119 | 374,663 | 444,064 | 491,665 |
| Tractors | 102,536 | 98,710 | 119,708 | 174,634 | 195,590 | 219,061 | 240,967 |
| Total vehicles | 264,111 | 281,395 | 318,169 | 456,753 | 570,253 | 663,125 | 732,632 |
| Growth (yoy %) | | | | | | | |
| Utility vehicles (incl. pickups) | 11.5 | 16.3 | 3.3 | 46.2 | 15.9 | 14.8 | 10.0 |
| LCVs | | | | | | 40.0 | 15.0 |
| 3-wheelers | 50.4 | 0.6 | 32.1 | (0.0) | 10.0 | 10.0 | 7.5 |
| Automotive segment | 17.8 | 13.1 | 8.6 | 42.2 | 32.8 | 18.5 | 10.7 |
| Tractors | 20.6 | (3.7) | 21.3 | 45.9 | 12.0 | 12.0 | 10.0 |
| Total vehicles | 18.9 | 6.5 | 13.1 | 43.6 | 24.8 | 16.3 | 10.5 |

Source: Company, Kotak Institutional Equities estimates

M&M, SOTP-based valuation, FY2012E basis

| | EPS (Rs/share) | Multiple (X) | Value per share (Rs) | Comment |
|-----------------------------------|-------------------|-----------------|----------------------------|--|
| M&M standalone business | 50 | 12 | 600 | Based on 12X average of FY2012E EPS less dividend income from subs |
| Subsidiaries | | | 160 | |
| Tech Mahindra | | | 51 | Based on current price of Rs710/share |
| Mahindra Holidays | | | 46 | Based on current price of Rs490/share |
| M&M Financial Services Ltd | | | 46 | Based on KIE target price of Rs500/share |
| Mahindra Lifespace Developers Ltd | | | 11 | Based on KIE target price of Rs540/share |
| Mahindra Forgings | | | 6 | Based on current price of Rs100/share |
| SOTP-based value | | | 761 | |
| Target price | | | 760 | |

Note

(1) The subsidiaries have been valued at a holding company discount of 20%.

Source: Company, Kotak Institutional Equities estimates

M&M, Profit model, balance sheet and cash flow model, March fiscal year-ends, 2007-2012E (Rs mn)

| | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E |
|---|---------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Profit model (Rs mn) | | | | | | | |
| Net sales | 100,682 | 115,413 | 130,937 | 186,021 | 233,929 | 270,541 | 301,926 |
| EBITDA | 13,048 | 13,666 | 10,926 | 29,552 | 35,464 | 41,875 | 48,225 |
| Other income | 1,530 | 1,304 | 2,703 | 1,994 | 2,290 | 2,715 | 2,865 |
| Interest | 675 | (242) | (453) | (278) | 388 | 907 | 1,049 |
| Depreciation | (2,096) | (2,387) | (2,915) | (3,708) | (4,034) | (4,979) | (5,924) |
| Profit before tax | 13,157 | 12,340 | 10,262 | 27,560 | 34,108 | 40,518 | 46,215 |
| Current tax | (3,657) | (2,788) | (585) | (7,493) | (7,845) | (9,724) | (11,092) |
| Deferred tax | 157 | (247) | (1,412) | (97) | — | — | — |
| Net profit | 10,684 | 11,034 | 8,368 | 20,878 | 26,263 | 30,793 | 35,124 |
| Adjusted earnings per share (Rs) | 18.9 | 18.2 | 14.8 | 33.9 | 44.1 | 51.7 | 59.0 |
| Balance sheet (Rs mn) | | | | | | | |
| Equity | 35,727 | 44,068 | 52,621 | 80,671 | 100,784 | 125,104 | 153,107 |
| Total Borrowings | 16,360 | 25,871 | 40,528 | 28,802 | 26,802 | 26,802 | 26,802 |
| Current liabilities | 26,656 | 32,400 | 47,978 | 52,000 | 62,547 | 69,356 | 75,326 |
| Total liabilities | 78,743 | 102,339 | 141,126 | 161,473 | 190,133 | 221,262 | 255,234 |
| Net fixed assets | 18,712 | 23,609 | 32,143 | 37,027 | 47,993 | 58,014 | 67,090 |
| Investments | 22,375 | 42,151 | 57,864 | 63,980 | 73,980 | 81,480 | 88,980 |
| Cash | 13,261 | 8,612 | 15,744 | 17,432 | 13,163 | 18,289 | 28,475 |
| Other current assets | 24,221 | 27,831 | 35,249 | 42,992 | 54,955 | 63,437 | 70,648 |
| Miscellaneous expenditure | 176 | 135 | 126 | 41 | 41 | 41 | 41 |
| Total assets | 78,743 | 102,339 | 141,126 | 161,473 | 190,133 | 221,262 | 255,234 |
| Free cash flow (Rs mn) | | | | | | | |
| Operating cash flow excl. working capital | 9,712 | 10,730 | 10,395 | 23,409 | 27,619 | 32,150 | 37,134 |
| Working capital changes | 1,978 | (2,472) | 5,918 | (45) | (1,416) | (1,673) | (1,242) |
| Capital expenditure | (4,819) | (7,171) | (9,152) | (9,607) | (15,000) | (15,000) | (15,000) |
| Free cash flow | 6,870 | 1,087 | 7,161 | 13,758 | 11,203 | 15,478 | 20,892 |
| Ratios | | | | | | | |
| Operating margin (%) | 13.0 | 11.8 | 8.3 | 15.9 | 15.2 | 15.5 | 16.0 |
| PAT margin (%) | 10.6 | 9.6 | 6.4 | 11.2 | 11.2 | 11.4 | 11.6 |
| Debt/equity (X) | 0.5 | 0.6 | 0.8 | 0.4 | 0.3 | 0.2 | 0.2 |
| Net debt/equity (X) | 0.0 | 0.0 | (0.4) | (0.5) | (0.5) | (0.5) | (0.6) |
| Book Value (Rs/share) | 69.6 | 86.0 | 89.1 | 135.4 | 169.2 | 210.0 | 257.1 |
| RoAE (%) | 29.3 | 23.4 | 17.1 | 30.0 | 29.0 | 27.3 | 25.3 |
| RoACE (%) | 20.1 | 15.6 | 10.6 | 19.9 | 21.9 | 21.5 | 20.7 |

Source: Company, Kotak Institutional Equities estimates

JULY 29, 2010
RESULT

Coverage view: **Attractive**

Price (Rs): **734**

Target price (Rs): **950**

BSE-30: **17,992**

Consistent performance will command premium valuations. BOB reported impressive earnings (up 25% yoy, 7% above estimates) for 1QFY11, on back of strong NII growth at 54%, as loans grew 30% and margins improved 53 bps yoy. We do not see any large issues on asset quality with gross NPLs at 1.4% and coverage of 73%. Slippages were at 1.5% of loans and overall restructured loans were at 3% of total loans. Focus remains on quality earnings, with RoA of 1.2% and RoEs at near 23%. BUY.

Company data and valuation summary

Bank of Baroda

| Stock data | | Forecasts/Valuations | | | |
|---------------------------------|--------------|----------------------|-------|-------|-------|
| | | 2010 | 2011E | 2012E | |
| 52-week range (Rs) (high,low) | 755-381 | EPS (Rs) | 83.7 | 95.1 | 115.7 |
| Market Cap. (Rs bn) | 268.4 | EPS growth (%) | 37.3 | 13.7 | 21.7 |
| Shareholding pattern (%) | | P/E (X) | 8.8 | 7.7 | 6.3 |
| Promoters | 53.8 | NII (Rs bn) | 59.4 | 75.4 | 91.6 |
| FIs | 16.5 | Net profits (Rs bn) | 30.6 | 34.8 | 42.3 |
| MFs | 9.1 | BVPS | 375.9 | 451.0 | 542.5 |
| Price performance (%) | | P/B (X) | 2.0 | 1.6 | 1.4 |
| Absolute | 1M 3M 12M | ROE (%) | 24.4 | 23.0 | 23.3 |
| | | Div. Yield (%) | 2.0 | 2.3 | 2.8 |
| Rel. to BSE-30 | 1.1 3.3 46.3 | | | | |

QUICK NUMBERS

- NII growth 54% yoy
NIMs at 2.9%
- Slippages lower at
1.5%
- Revising TP to Rs950
(from Rs825 earlier)

Outlook on core earnings gets better with every quarter; remains as our preferred pick

We maintain our BUY rating on BOB with a target price of Rs950 (Rs825 earlier), moving to FY2012E multiples. The bank has consistently been delivering better than expected on most operating parameters. Margins have remained stable qoq (2.9% levels, 3.4% for domestic business), loan growth ahead of industry (27% yoy) and asset quality has held well. Incremental addition to NPLs (at 1.5% in 1QFY10), along with a lower proportion of restructured assets (3% of loans, facility wise) is commendable. We build in conservative earnings growth of 14% in FY2011E, as strong treasury income and write-backs are unlikely to be repeated. However, the bank has levers to do well on loan loss provisions and expenses, compared to our earnings. The stock trades at 1.4X FY2012E PBR for a near-term RoE of about 23%, which is attractive.

Loan growth ahead of the industry at 30%; deposit growth at 28%

Global loans grew by 30% yoy (6% qoq) to Rs1.86 tn as of June 2010, while domestic loans grew by 27% yoy and international loans by 38% yoy. Domestic deposits were Rs1.96 tn (up 27% yoy) and given the management's thrust on improving its liability profile, growth in low-cost deposits was at 28% yoy —CASA ratio was stable at 35.2%. The management has guided to grow upwards of 25% in loans in FY2011E.

Margins remain impressive despite the savings and CRR impact

NIMs for 1QFY11 was maintained sequentially at about 2.90% (2.97% in 4QFY10) despite higher savings deposit costs and higher CRR impacting deposit costs. Deposit costs declined by 3 bps qoq to 4.39%, while yields declined by 6 bps qoq. CD ratio for the quarter was stable at 73%. Net interest income grew by 54% yoy and 6% qoq to Rs18.6 bn. Domestic margins are now at 3.4% (down just 7 bps qoq). International margins were stable at 1.3% qoq. The management expects limited impact from the new base rate system, and would strive to sustain margins at 3.4-3.5% over the rest of the year.

Manish Karwa
manish.karwa@kotak.com
Mumbai: +91-22-6634-1350

M B Mahesh
mb.mahesh@kotak.com
Mumbai: +91-22-6634-1231

Nischint Chawathe
nischint.chawathe@kotak.com
Mumbai: +91-22-6634-1545

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Muted non-interest income performance; sharp decline in treasury income

Non-interest income declined 12% yoy to Rs6.2 bn in 1QFY11 mainly due to lower fee and treasury and income. Fee income growth was disappointing at 3% yoy as credit activity was relatively subdued. With loan growth we expect traction in fee income to improve. Treasury gains were lower at Rs1.3 bn (down 50% yoy). Recoveries were up 12% at Rs561 mn.

Asset quality trend is comfortable; provision coverage healthy at 86%

One of the key positives has been the bank's ability to manage asset quality in the current environment. Reported gross NPL ratio and net NPL ratio as of June 2010 were at 1.4% and 0.3% with a provision coverage ratio (inc. w/o) at 86% (73% excluding w/o). Gross NPLs increased by 10% qoq largely on account of corporate and retail loans. Agri loans pertaining to debt waiver have already been classified as NPLs. BoB's incremental delinquencies during 1QFY10 were Rs6.4 bn, which is 1.5% (annualized) of the loan book. The management appears confident of maintaining its delinquency within 1.5% levels in FY2011E.

Restructured assets increases marginally, but remain low at 3% (facility wise)

The bank has restructured Rs53 bn as of June 2010 (for 24 months), up by Rs4.2 bn in June 2009. Overall restructured assets are 2.8% (facility wise) of the loan book. Out of the total restructured book, about Rs4.8 bn of loans (Rs10 mn and above forming 9% of restructured loans) slipped into the NPL category during the last 5 quarters.

Bank of Baroda, Quarterly results

March fiscal year-ends, 1QFY10-1QFY11 (Rs mn)

| | 1QFY10 | 2QFY10 | 3QFY10 | 4QFY10 | 1QFY11 | % chg | 1QFY11E | Actual Vs KS |
|---|---------------|---------------|---------------|---------------|---------------|-----------|---------------|-----------------|
| Interest income | 40,321 | 41,354 | 41,770 | 43,538 | 47,270 | 17 | 44,445 | 6 |
| Interest on advances | 30,366 | 31,014 | 31,571 | 32,461 | 35,658 | 17 | 33,111 | 8 |
| Income from invts | 8,902 | 9,275 | 9,132 | 9,250 | 10,224 | 15 | 9,434 | 8 |
| Bal with RBI | 1,053 | 1,065 | 1,067 | 1,828 | 1,388 | 32 | 1,900 | (27) |
| Interest expenses | 28,274 | 27,468 | 25,757 | 26,089 | 28,690 | 1 | 27,393 | 5 |
| Net interest income | 12,047 | 13,886 | 16,012 | 17,450 | 18,580 | 54 | 17,052 | 9 |
| Non-interest income | 7,030 | 5,953 | 6,597 | 8,483 | 6,172 | (12) | 7,595 | (19) |
| Other income (excl'd treasury) | 4,476 | 4,748 | 5,230 | 6,415 | 4,893 | 9 | 5,595 | (13) |
| Other income (excl'd treasury and recoveries) | 3,977 | 4,082 | 4,575 | 5,234 | 4,332 | 9 | 4,772 | — |
| Forex income | 963 | 842 | 987 | 1,067 | 1,216 | 26 | 1,067 | — |
| Treasury income | 2,554 | 1,205 | 1,367 | 2,068 | 1,279 | (50) | 2,000 | (36) |
| Total income | 19,077 | 19,839 | 22,609 | 25,933 | 24,752 | 30 | 24,647 | 0 |
| Operating expenses | 8,978 | 9,523 | 9,959 | 9,645 | 9,474 | 6 | 10,180 | (7) |
| Employee expenses | 5,942 | 5,958 | 6,292 | 5,318 | 5,767 | (3) | 6,536 | (12) |
| Other operating expenses | 3,036 | 3,566 | 3,668 | 4,327 | 3,706 | 22 | 3,644 | 2 |
| Operating profit | 10,099 | 10,316 | 12,649 | 16,288 | 15,279 | 51 | 14,467 | 6 |
| Provisions | (390) | 1,163 | 2,425 | 3,773 | 2,513 | (745) | 3,019 | (17) |
| Loan loss | 3,171 | 1,737 | 2,447 | 2,318 | 2,775 | (12) | 2,000 | 39 |
| Inv't. depreciation | (3,598) | (611) | (216) | 617 | (589) | (84) | 617 | (195) |
| PBT | 10,489 | 9,153 | 10,225 | 12,515 | 12,765 | 22 | 11,448 | 12 |
| Taxation | 3,635 | 2,810 | 1,900 | 3,452 | 4,174 | 15 | 3,435 | 22 |
| Net profit | 6,854 | 6,342 | 8,325 | 9,063 | 8,592 | 25 | 8,014 | 7 |
| PBT-inv't gains/losses | 4,337 | 7,337 | 8,642 | 11,063 | 10,897 | 151 | 10,065 | 8 |
| PBT-inv't gains + provisions | 7,508 | 9,073 | 11,089 | 13,382 | 13,672 | 82 | 12,065 | 13 |
| Tax rate | 34.7 | 30.7 | 18.6 | 27.6 | 32.7 | | 30.0 | — |

Source: Company, Kotak Institutional Equities estimates

Bank of Baroda, Key ratios and growth rates, March fiscal year-ends (%)

| | 1QFY10 | 2QFY10 | 3QFY10 | 4QFY10 | 1QFY11 | % chg |
|--|--------|--------|--------|--------|--------|-------|
| Key balance sheet items (Rs bn) | | | | | | |
| Deposits | 1,986 | 2,074 | 2,151 | 2,410 | 2,547 | 28 |
| Domestic | 1,544 | 1,606 | 1,662 | 1,853 | 1,962 | 27 |
| CASA ratio (%) | 35.1 | 36.2 | 36.9 | 35.6 | 35.2 | — |
| Foreign | 442 | 467 | 467 | 558 | 585 | 32 |
| Advances | 1,427 | 1,489 | 1,562 | 1,750 | 1,856 | 30 |
| Domestic | 1,066 | 1,096 | 1,160 | 1,316 | 1,357 | 27 |
| Retail loans | 202 | 214 | 223 | 242 | 250 | 24 |
| Home loans | 87 | 94 | 94 | 103 | 108 | 23 |
| SME | 151 | 167 | 202 | 211 | 216 | 43 |
| Farm credit | 180 | 186 | 188 | 216 | 211 | 17 |
| Foreign | 361 | 393 | 402 | 434 | 499 | 38 |
| Investments | 565.4 | 579.5 | 576.6 | 611.8 | 666.4 | 17.9 |
| Domestic | 528.6 | 540.7 | 538.5 | 579.1 | 629.6 | 19.1 |
| International | 36.8 | 38.8 | 38.0 | 34.9 | 36.8 | (0.0) |
| AFS | 123 | 99 | 100 | 104 | 116 | (6) |
| Duration (years) | 3.0 | 2.1 | 2.2 | 2.2 | 2.2 | |
| Yield management measures (%) | | | | | | |
| Average cost of deposits | 5.41 | 5.15 | 5.11 | 4.90 | 4.39 | |
| Avg. cost of deposits (domestic) | 6.16 | 5.87 | 5.80 | 5.60 | 5.09 | |
| Avg. cost of deposits (international) | 2.65 | 2.49 | 2.54 | 2.37 | 1.95 | |
| Yield on advances (total) | 8.72 | 8.71 | 8.71 | 8.23 | 8.17 | |
| Yield on advances (domestic) | 10.10 | 10.23 | 10.17 | 9.76 | 9.79 | |
| Yield on advances (international) | 4.69 | 4.48 | 4.47 | 3.74 | 3.67 | |
| Yield on investments (total) | 6.83 | 6.69 | 6.71 | 6.51 | 6.66 | |
| Yield on investments (domestic) | 7.07 | 6.87 | 6.92 | 6.72 | 6.83 | |
| Yield on investments (international) | 3.87 | 4.33 | 3.96 | 3.68 | 3.71 | |
| NIM | 2.37 | 2.63 | 2.95 | 2.97 | 2.90 | |
| Asset quality details | | | | | | |
| Gross NPLs (Rs bn) | 20.7 | 19.6 | 22.6 | 24.0 | 26.6 | 28.5 |
| Gross NPLs (%) | 1.6 | 1.3 | 1.4 | 1.4 | 1.4 | |
| Net NPLs (Rs bn) | 3.8 | 4.1 | 4.9 | 6.0 | 7.2 | 89.5 |
| Net NPLs (%) | 0.3 | 0.3 | 0.3 | 0.3 | 0.4 | - |
| Provision Coverage | 81.7 | 79.3 | 78.5 | 74.9 | 73.0 | |
| Restructured Loans | 42.0 | 46.0 | 48.0 | 51.4 | 52.8 | 25.8 |
| % of loans | 2.9 | 3.1 | 3.1 | 2.9 | 2.8 | |
| Capital adequacy details (%) | | | | | | |
| CAR | 14.6 | 14.7 | 14.7 | 14.4 | 13.3 | |
| Tier I | 8.8 | 8.9 | 9.3 | 9.2 | 8.2 | |
| Tier II | 5.8 | 5.8 | 5.3 | 5.2 | 5.1 | |

Source: Company, Kotak Institutional Equities estimates

We marginally increase our near-term estimates by around 10%

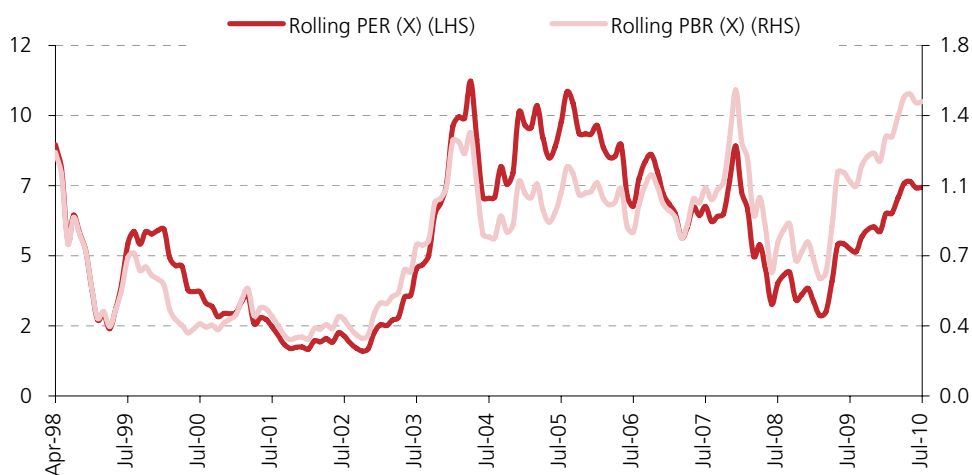
Old and new estimates, March fiscal year-ends, 2011-2012E (Rs mn)

| | Old Estimates | | New Estimates | | % change | |
|-------------------------------------|---------------|---------------|---------------|---------------|------------|------------|
| | 2011E | 2012E | 2011E | 2012E | 2011E | 2012E |
| NII | 74,953 | 90,776 | 75,367 | 91,628 | 0.6 | 0.9 |
| Loan growth | 23.5 | 23.6 | 23.4 | 23.6 | | |
| NIM | 2.5 | 2.5 | 2.5 | 2.5 | | |
| Non-treasury other inc | 24,945 | 29,477 | 24,623 | 28,863 | (1.3) | (2.1) |
| Operating expenses | 44,652 | 51,138 | 42,829 | 49,311 | (4.1) | (3.6) |
| Employee expenses | 27,421 | 31,069 | 25,658 | 29,070 | (6.4) | (6.4) |
| Provisions and contingencies | | | | | | |
| Loan loss prov | 9,388 | 11,601 | 9,383 | 12,070 | (0.1) | 4.0 |
| PBT | 48,252 | 59,657 | 51,119 | 62,201 | 5.9 | 4.3 |
| PAT | 32,811 | 40,567 | 34,761 | 42,297 | 5.9 | 4.3 |
| PBT- invt gains + provisions | 55,247 | 69,115 | 57,161 | 71,180 | 3.5 | 3.0 |

Source: Company, Kotak Institutional Equities estimates

Bank of Baroda- Rolling PER and PBR

August 1997-April 2010 (X)



Source: Kotak Institutional Equities

Bank of Baroda, Key ratios and growth rates
March fiscal year-ends, 2008-2013E (%)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|------------------------------------|------------|------------|------------|------------|------------|------------|
| Growth rates (%) | | | | | | |
| Net loan | 22.6 | 31.6 | 13.0 | 16.0 | 20.0 | 19.0 |
| Total Asset | 25.5 | 26.6 | 22.4 | 21.2 | 20.8 | 20.5 |
| Deposits | 21.7 | 26.5 | 25.3 | 23.4 | 22.6 | 21.9 |
| Current | 18.4 | 23.6 | 30.9 | 23.4 | 22.6 | 21.9 |
| Savings | 13.3 | 18.8 | 23.7 | 23.4 | 22.6 | 21.9 |
| Fixed | 25.3 | 29.5 | 25.2 | 23.4 | 22.6 | 21.9 |
| Net interest income | 3.3 | 31.0 | 15.9 | 26.9 | 21.6 | 20.3 |
| Loan loss provisions | 57.4 | (34.9) | 157.1 | (11.7) | 28.6 | 35.3 |
| Total other income | 49.8 | 29.8 | 5.4 | 2.0 | 14.8 | 16.7 |
| Net fee income | 14.2 | 38.0 | 20.4 | 22.0 | 20.0 | 20.0 |
| Net capital gains | 290.9 | 69.1 | (19.7) | (44.7) | — | 12.5 |
| Net exchange gains | 16.5 | 33.6 | 3.6 | 16.0 | 15.0 | 15.0 |
| Operating expenses | 17.1 | 20.0 | 6.6 | 12.4 | 15.1 | 19.3 |
| Employee expenses | 12.5 | 27.0 | 0.1 | 9.1 | 13.3 | 19.6 |
| Key ratios (%) | | | | | | |
| Yield on average earning assets | 7.7 | 7.7 | 6.8 | 7.1 | 7.3 | 7.6 |
| Yield on average loans | 8.8 | 8.9 | 7.9 | 8.2 | 8.4 | 8.7 |
| Yield on average investments | 7.2 | 7.1 | 6.7 | 6.9 | 7.1 | 7.3 |
| Average cost of funds | 5.4 | 5.4 | 4.7 | 4.9 | 5.1 | 5.5 |
| Interest on deposits | 5.3 | 5.3 | 4.6 | 4.9 | 5.1 | 5.5 |
| Difference | 2.3 | 2.3 | 2.1 | 2.2 | 2.2 | 2.2 |
| Net interest income/earning assets | 2.6 | 2.6 | 2.4 | 2.5 | 2.5 | 2.5 |
| New provisions/average net loans | 0.7 | 0.3 | 0.6 | 0.5 | 0.5 | 0.6 |
| Interest income/total income | 72.2 | 73.7 | 74.3 | 75.6 | 76.3 | 76.7 |
| Fee income to total income | 9.1 | 9.6 | 10.3 | 10.5 | 10.6 | 10.6 |
| Operating expenses/total income | 55.0 | 51.5 | 47.7 | 43.0 | 41.1 | 41.0 |
| Tax rate | 35.0 | 34.4 | 30.0 | 32.0 | 32.0 | 32.0 |
| Dividend payout ratio | 20.4 | 14.8 | 17.9 | 17.9 | 17.9 | 17.9 |
| Share of deposits | | | | | | |
| Current | 7.7 | 7.5 | 7.9 | 7.9 | 7.9 | 7.9 |
| Fixed | 68.8 | 70.4 | 70.4 | 70.4 | 70.4 | 70.4 |
| Savings | 23.5 | 22.1 | 21.8 | 21.8 | 21.8 | 21.8 |
| Loans-to-deposit ratio | 70.2 | 74.8 | 72.6 | 72.6 | 73.2 | 73.5 |
| Equity/assets (EoY) | 6.1 | 5.6 | 5.4 | 5.3 | 5.1 | 5.0 |
| Dupont analysis (%) | | | | | | |
| Net interest income | 2.4 | 2.5 | 2.3 | 2.4 | 2.5 | 2.5 |
| Loan loss provisions | 0.4 | 0.2 | 0.4 | 0.3 | 0.3 | 0.4 |
| Net other income | 1.3 | 1.3 | 1.1 | 0.9 | 0.9 | 0.9 |
| Operating expenses | 1.9 | 1.8 | 1.5 | 1.4 | 1.3 | 1.3 |
| Invnt. depreciation | — | 0.3 | (0.2) | — | — | — |
| (1- tax rate) | 65.0 | 66.6 | 72.2 | 68.0 | 68.0 | 68.0 |
| ROA | 0.9 | 1.1 | 1.2 | 1.1 | 1.1 | 1.1 |
| Average assets/average equity | 18.0 | 19.6 | 20.2 | 20.4 | 20.5 | 20.6 |
| ROE | 16.0 | 21.4 | 24.4 | 23.0 | 23.3 | 22.6 |

Source: Company, Kotak Institutional Equities estimates

Bank of Baroda, P&L and balance sheet
March fiscal year-ends, 2008-2013E (Rs mn)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|--|------------------|------------------|------------------|------------------|------------------|------------------|
| Income statement | | | | | | |
| Total interest income | 118,135 | 150,916 | 166,983 | 214,749 | 268,311 | 338,777 |
| Loans | 84,130 | 111,974 | 125,412 | 159,653 | 203,687 | 258,492 |
| Investments | 27,373 | 33,107 | 36,559 | 45,916 | 58,677 | 73,787 |
| Cash and deposits | 6,632 | 5,836 | 5,012 | 9,179 | 5,947 | 6,498 |
| Total interest expense | 79,017 | 99,682 | 107,589 | 139,382 | 176,684 | 228,581 |
| Deposits from customers | 74,044 | 91,875 | 98,807 | 132,280 | 169,582 | 221,479 |
| Net interest income | 39,118 | 51,234 | 59,395 | 75,367 | 91,628 | 110,196 |
| Loan loss provisions | 6,347 | 4,131 | 10,621 | 9,383 | 12,070 | 16,325 |
| Net interest income (after prov.) | 32,771 | 47,104 | 48,774 | 65,984 | 79,557 | 93,871 |
| Other income | 20,507 | 26,626 | 28,064 | 28,623 | 32,863 | 38,350 |
| Net fee income | 5,402 | 7,455 | 8,973 | 10,947 | 13,136 | 15,764 |
| Net capital gains | 5,322 | 9,001 | 7,232 | 4,000 | 4,000 | 4,500 |
| Net exchange gains | 2,788 | 3,724 | 3,860 | 4,477 | 5,149 | 5,921 |
| Operating expenses | 29,793 | 35,761 | 38,106 | 42,829 | 49,311 | 58,840 |
| Employee expenses | 18,488 | 23,481 | 23,509 | 25,658 | 29,070 | 34,768 |
| Depreciation on investments | 418 | 5,368 | (3,807) | 500 | 750 | 750 |
| Other Provisions | 1,000 | 123 | 159 | 159 | 159 | 159 |
| Pretax income | 22,068 | 32,479 | 42,381 | 51,119 | 62,201 | 72,472 |
| Tax provisions | 7,716 | 11,157 | 11,797 | 16,358 | 19,904 | 23,191 |
| Net Profit | 14,355 | 22,272 | 30,583 | 34,761 | 42,297 | 49,281 |
| % growth | 40 | 55 | 37 | 14 | 22 | 17 |
| PBT - treasury gains + provisions | 24,510 | 33,098 | 42,120 | 57,161 | 71,180 | 85,206 |
| % growth | 8 | 35 | 27 | 36 | 25 | 20 |
| Balance sheet | | | | | | |
| Cash and bank balance | 222,993 | 240,871 | 354,671 | 379,689 | 413,225 | 453,199 |
| Cash | 8,810 | 9,990 | 11,731 | 11,731 | 11,731 | 11,731 |
| Balance with RBI | 84,887 | 95,974 | 123,669 | 148,688 | 182,223 | 222,197 |
| Balance with banks | 13,945 | 14,034 | 9,143 | 9,143 | 9,143 | 9,143 |
| Net value of investments | 438,701 | 524,459 | 611,824 | 769,118 | 931,675 | 1,132,298 |
| Govt. and other securities | 335,480 | 401,347 | 494,425 | 659,673 | 822,229 | 1,022,852 |
| Shares | 7,758 | 6,061 | 12,319 | 12,319 | 12,319 | 12,319 |
| Debentures and bonds | 26,033 | 30,140 | 23,518 | 23,518 | 23,518 | 23,518 |
| Net loans and advances | 1,067,013 | 1,439,859 | 1,750,353 | 2,159,406 | 2,668,685 | 3,267,839 |
| Fixed assets | 24,270 | 23,468 | 22,848 | 23,092 | 22,710 | 22,252 |
| Net leased assets | — | — | — | — | — | — |
| Net Owned assets | 24,270 | 23,468 | 22,848 | 23,092 | 22,710 | 22,252 |
| Other assets | 43,018 | 45,781 | 43,472 | 41,280 | 39,198 | 37,221 |
| Total assets | 1,795,995 | 2,274,438 | 2,783,167 | 3,372,585 | 4,075,492 | 4,912,809 |
| Deposits | 1,520,341 | 1,923,970 | 2,410,443 | 2,973,757 | 3,644,469 | 4,443,948 |
| Borrowings and bills payable | 110,635 | 139,713 | 147,950 | 147,950 | 147,950 | 147,950 |
| Other liabilities | 54,580 | 82,400 | 73,710 | 73,710 | 73,710 | 73,710 |
| Total liabilities | 1,685,556 | 2,146,082 | 2,632,103 | 3,195,418 | 3,866,130 | 4,665,609 |
| Paid-up capital | 3,655 | 3,655 | 3,655 | 3,655 | 3,655 | 3,655 |
| Reserves & surplus | 106,784 | 124,700 | 147,409 | 173,512 | 205,707 | 243,545 |
| Total shareholders' equity | 110,439 | 128,355 | 151,064 | 177,167 | 209,363 | 247,200 |

Source: Company, Kotak Institutional Equities estimates

JULY 29, 2010

RESULT

Coverage view: **Attractive**

Price (Rs): **378**

Target price (Rs): **390**

BSE-30: **17,992**

4QFY10 results – a mixed bag. HCLT reported in-line EBITDA and net income for the June 2010 quarter despite beating our revenue estimates by a robust 4.2%, validating our thesis of potential margin pressure arising out of aggressive deal signings. Even as we expect the strong revenue momentum to sustain, margin pressure and investments in BPO platform development will keep EBITDA growth trajectory below frontline peers. We retain our REDUCE rating with a revised target price of Rs390/share (Rs370 earlier).

Company data and valuation summary

HCL Technologies

Stock data

| | |
|-------------------------------|---------|
| 52-week range (Rs) (high,low) | 449-232 |
| Market Cap. (Rs bn) | 260.9 |

Shareholding pattern (%)

| | |
|-----------|------|
| Promoters | 68.1 |
| FIs | 19.9 |
| MFs | 2.1 |

Price performance (%)

| | 1M | 3M | 12M |
|----------------|-----|-------|------|
| Absolute | 4.8 | (1.9) | 60.5 |
| Rel. to BSE-30 | 2.2 | (4.6) | 35.3 |

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|-------|-------|-------|
| EPS (Rs) | 17.5 | 24.5 | 30.1 |
| EPS growth (%) | 0.2 | 39.7 | 23.0 |
| P/E (X) | 21.6 | 15.4 | 12.6 |
| Sales (Rs bn) | 125.7 | 153.6 | 180.7 |
| Net profits (Rs bn) | 13.2 | 17.6 | 21.3 |
| EBITDA (Rs bn) | 24.8 | 27.6 | 32.7 |
| EV/EBITDA (X) | 10.5 | 9.2 | 7.5 |
| ROE (%) | 19.3 | 22.0 | 21.2 |
| Div. Yield (%) | 1.1 | 1.1 | 1.6 |

Revenue performance impressive, margins disappoint

HCLT reported strong 7.7% sequential US\$ revenue growth (9.1% in constant currency) for the June 2010 quarter, beating our estimate of US\$708 mn by 4.2%. More importantly, unlike the past few quarters, revenue growth was more broad-based—the company reported a robust 9.4% growth in its IT services business, even as strong growth momentum in IMS sustained (+8.9% qoq, in line with expectations). BPO remained a weak spot, with revenues declining a sharp 12.5% qoq.

Positive surprise on the revenue line failed to translate into EBITDA or net income surprise as the company reported lower-than-expected margins and higher-than-expected forex losses for the quarter. EBITDA margins declined 110 bps qoq to 17.9% versus our expectation of flat margins. We note that HCLT has not effected wage hikes for its employees yet.

HCLT results lend further weight to our positive demand outlook for the industry

HCLT results further validated our positive outlook on demand environment, especially for the larger players – (1) strong sequential revenue growth in IT services and IMS segments (10.7% and 10.2%, in constant currency terms), (2) record single-quarter net hiring (6,428) as well as gross lateral hiring, (3) broad-based nature of revenue growth, (4) robust new client additions (51 during the quarter), and (5) strong client metrics – HCLT reported 4.9% qoq growth in its top-5 and 5.9% in its top-10 customer relationships. Also, the company reported strong growth in some of the 'discretionary' service lines (11.7% qoq growth in EAS, 11% in engineering services).

Concerns on margin trajectory remain

Even as we take a more positive view on revenue growth for HCLT over the coming quarters (on the back of our optimism on sector demand and ramp-up of recent large deals won by HCLT), we see several challenges to margin improvement, some company-specific and some industry-wide – (1) wage pressure – we note that HCLT is yet to effect wage hikes for its employees; more importantly, the company reiterated its stance of sticking to just-in-time lateral hiring to meet demand – this makes the company vulnerable to sustenance of high employee churn in the industry, (2) guidance of losses in the BPO business continuing for the next few quarters as the company 'reboots' its BPO business, and (3) possibility of increased aggression on new deals.

Kawaljeet Saluja
kawaljeet.saluja@kotak.com
Mumbai: +91-22-6634-1243

Rohit Chordia
rohit.chordia@kotak.com
Mumbai: +91-22-6634-1397

Vineet Thodge
vineet.thodge@kotak.com
Mumbai: +91-22-6634-1225

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

4QFY10 highlights – impressive revenue metrics, cost pressure evident

- ▶ Impressive 7.7% qoq and 21.5% yoy US\$ revenue growth failed to translate into EBITDA growth. EBITDA in US\$ terms grew <2% qoq and <1% yoy, as margins fell 110 bps qoq, and 370 bps yoy.
- ▶ Revenue growth was broad-based across business segments (excluding the under-transformation BPO), verticals, geographies, and client buckets.
- ▶ Client metrics were strong – HCLT added 51 clients during the quarter, top-5 clients grew 4.9% and top-10 clients grew 5.5% qoq.
- ▶ Net hiring was robust at 6,428. More importantly, the company hired 8,151 laterals (gross).
- ▶ HCLT reported US\$5.2 mn of EBITDA loss in its BPO segment. The company indicated that it is executing its 3-year 'rebooting' plan for its BPO segment, the key elements of which being (1) identifying key focus areas and ring-fencing non-focus areas, and (2) investments in a few strategic areas – specifically, the company mentioned that it would invest US\$30 mn in developing a platform for the insurance vertical over eight quarters.
- ▶ Attrition (LTM) jumped 180 bps qoq to 15.7% in the IT services segment.

Raise revenue estimates but reduce margin assumptions; reiterate REDUCE

We have raised our FY2011E and FY2012E revenue estimates for HCLT by 4.6% and 7.5% to US\$3.33 bn and US\$3.95 bn, respectively. However, a 140 bps downward revision in our FY2011E OPM assumption leads to a 2.4% cut in FY2011E estimate to Rs24.5/share. We do raise our FY2012E EPS estimate to Rs30.1/share and our target price to Rs390/share (on roll-forward to end-June 2012E). We retain our REDUCE rating on the stock.

Exhibit 1: Key Changes to our FY2011-12E estimates

| US\$ mn | Revised | | Old | | Change (%) | |
|-------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| | FY2011E | FY2012E | FY2011E | FY2012E | FY2011E | FY2012E |
| Revenues | 3,332 | 3,950 | 3,186 | 3,675 | 4.6 | 7.5 |
| - Software Services | 2,379 | 2,806 | 2,241 | 2,595 | 6.1 | 8.1 |
| - BPO | 174 | 181 | 190 | 205 | (8.5) | (11.6) |
| - Infrastructure Services | 779 | 963 | 754 | 875 | 3.3 | 10.1 |
| Revenue growth yoy (%) | 23.2 | 18.6 | 18.9 | 15.4 | | |
| EBITDA | 600 | 681 | 617 | 708 | (2.8) | (3.8) |
| EBIT | 484 | 551 | 498 | 577 | (2.8) | (4.6) |
| Net Income | 367 | 417 | 383 | 434 | (4.4) | (4.0) |
| EBITDA margin (%) | 18.0 | 17.2 | 19.4 | 19.3 | | |
| EBIT | 14.5 | 13.9 | 15.6 | 15.7 | | |
| Re/ US\$ rate | 46.1 | 45.3 | 45.1 | 45.3 | 2.1 | — |
| EPS Rs/ share | 24.5 | 30.1 | 25.1 | 28.5 | (2.4) | 5.7 |

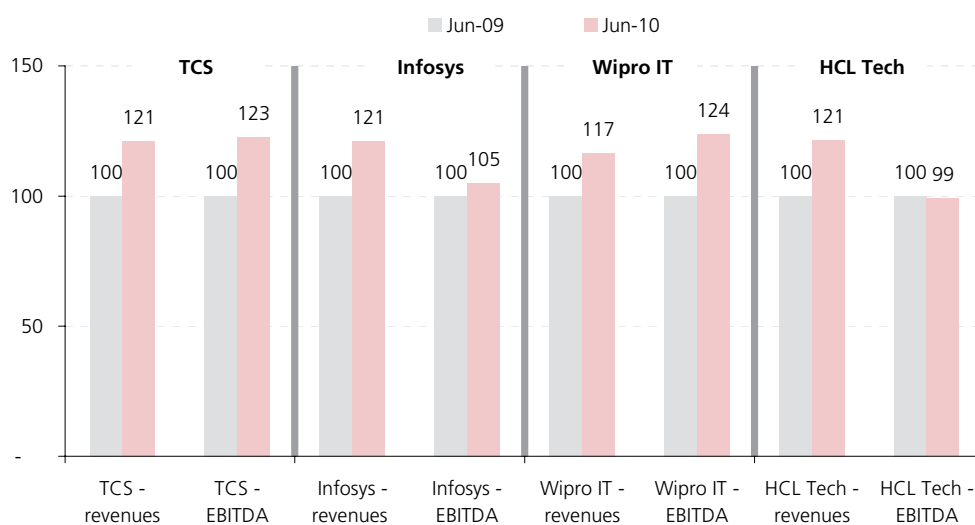
Source: Kotak Institutional Equities estimates

Exhibit2: HCL Technologies (year-ending June) - 4QFY10 financial performance

| Rs mn | 4QFY09 | 3QFY10 | 4QFY10 | qoq (%) | yoy (%) | Kotak estimates | % Deviation |
|--|---------------|---------------|---------------|---------------|---------------|-----------------|---------------|
| Revenues (US\$ mn) | 607.2 | 685.2 | 737.6 | 7.6 | 21.5 | 707.8 | 4.2 |
| Revenues | 29,085 | 30,757 | 34,254 | 11.4 | 17.8 | 32,773 | 4.5 |
| Cost of Revenues | (18,293) | (20,617) | (23,165) | 12.4 | 26.6 | (21,957) | 5.5 |
| Gross profit | 10,792 | 10,140 | 11,089 | 9.4 | 2.8 | 10,816 | 2.5 |
| SG&A expenses | (4,512) | (4,305) | (4,950) | 15.0 | 9.7 | (4,595) | 7.7 |
| EBITDA (including RSU expenses) | 6,280 | 5,835 | 6,139 | 5.2 | (2.2) | 6,222 | (1.3) |
| EBITDA adjusted for non cash RSU charges | 6,438 | 6,073 | 6,381 | 5.1 | (0.9) | 6,463 | (1.3) |
| Depreciation | (1,193) | (1,100) | (1,131) | 2.8 | (5.2) | (1,200) | (5.7) |
| EBIT | 5,087 | 4,736 | 5,008 | 5.8 | (1.6) | 5,022 | (0.3) |
| Interest expense | (465) | (449) | (450) | | | (448) | |
| Other Income (net of interest expense) | (536) | (319) | (1,128) | 253.9 | 110.3 | (671) | 68.1 |
| Earnings before tax | 4,086 | 3,968 | 3,430 | (13.6) | (16.1) | 3,903 | (12.1) |
| Provision for Tax | (934) | (768) | (254) | (66.9) | (72.8) | (703) | (63.8) |
| Earnings before share of earnings in affiliates | 3,152 | 3,200 | 3,176 | (0.8) | 0.8 | 3,201 | (0.8) |
| Share of income (loss) of equity investees | 2 | — | — | | | — | |
| Minority Interest | (5) | — | — | | | — | |
| Net Income (before extraordinary) | 3,149 | 3,200 | 3,176 | (0.8) | 0.9 | 3,201 | (0.8) |
| EPS | 4.6 | 4.6 | 4.6 | (0.8) | 0.9 | 4.6 | (0.8) |
| No of shares outstanding | 690.0 | 690.0 | 690.0 | | | 690.0 | |
| Margins (%) | | | | | | | |
| Gross Profit margin | 37.1 | 33.0 | 32.4 | | | 33.0 | |
| EBITDA Margin | 21.6 | 19.0 | 17.9 | | | 19.0 | |
| EBIT Margin | 17.5 | 15.4 | 14.6 | | | 15.3 | |
| NPM | 10.8 | 10.4 | 9.3 | | | 9.8 | |

Source: Company, Kotak Institutional Equities estimates

Exhibit 3: HCL Tech has lagged in EBITDA growth despite tracking revenue growth



Source: Companies, Kotak Institutional Equities

Exhibit 4: HCLT 4QFY10 performance

| | Reported | KIE est. | 3QFY10 | 4QFY09 |
|--|---------------|---------------|---------------|---------------|
| Headline financials | | | | |
| Revenues (US\$ mn) | 738 | 708 | 685 | 607 |
| Growth qoq (%) | 7.6 | 3.3 | | |
| Growth yoy (%) | 21.5 | 16.6 | | |
| versus KIE (%) | 4.2 | | | |
| Revenue (Rs mn) | | | | |
| Revenue (Rs mn) | 34,254 | 32,773 | 30,757 | 29,085 |
| Growth qoq (%) | 11.4 | 6.6 | | |
| Growth yoy (%) | 17.8 | 12.7 | | |
| versus KIE (%) | 4.5 | | | |
| EBITDA (Rs mn) | | | | |
| EBITDA (Rs mn) | 6,139 | 6,222 | 5,835 | 6,280 |
| Growth qoq (%) | 5.2 | 6.6 | | |
| Growth yoy (%) | (2.2) | (0.9) | | |
| versus KIE (%) | (1.3) | | | |
| EBITDA margin (%) | 17.9 | 19.0 | 19.0 | 21.6 |
| PAT (Rs mn) | | | | |
| PAT (Rs mn) | 3,176 | 3,201 | 3,200 | 3,147 |
| Growth qoq (%) | (0.7) | 0.0 | | |
| Growth yoy (%) | 0.9 | 1.7 | | |
| versus KIE (%) | (0.8) | | | |
| EPS (Rs/share) | | | | |
| EPS (Rs/share) | 4.60 | 4.64 | 4.64 | 4.56 |
| Growth qoq (%) | (0.7) | 0.0 | | |
| Growth yoy (%) | 0.9 | 1.7 | | |
| versus KIE (%) | (0.8) | | | |
| Revenue break-up | | | | |
| IT services (US\$ mn) | | | | |
| IT services (US\$ mn) | 527 | 493 | 481 | 442 |
| Growth qoq (%) | 9.4 | 2.4 | | |
| Growth yoy (%) | 19.3 | 11.7 | | |
| versus KIE (%) | 6.9 | | | |
| Infrastructure services (US\$ mn) | | | | |
| Infrastructure services (US\$ mn) | 165 | 165 | 152 | 107 |
| Growth qoq (%) | 8.9 | 9.0 | | |
| Growth yoy (%) | 54.3 | 54.5 | | |
| versus KIE (%) | (0.1) | | | |
| BPO (US\$ mn) | | | | |
| BPO (US\$ mn) | 46 | 49 | 52 | 59 |
| Growth qoq (%) | (12.5) | (5.1) | | |
| Growth yoy (%) | (22.4) | (15.8) | | |
| versus KIE (%) | (7.8) | | | |

Source: Company, Kotak Institutional Equities estimates

Exhibit 5: Key assumptions driving HCLT earnings model, 2009-2012E, June fiscal year-ends

| | 2009 | 2010E | 2011E | 2012E |
|--|---------------|---------------|---------------|---------------|
| Key assumptions | | | | |
| Revenue growth (US\$ terms) (%) | 16.4 | 23.6 | 23.2 | 18.6 |
| IT services | 16.3 | 20.2 | 24.0 | 18.0 |
| Infrastructure management | 25.6 | 60.6 | 36.3 | 23.6 |
| BPO | 5.6 | (9.3) | (18.8) | 4.1 |
| Volume growth yoy (%) (IT) | 12.4 | 11.4 | 25.5 | 16.6 |
| Pricing change yoy (%) | | | | |
| Onsite | 6.1 | 12.8 | (0.5) | 1.7 |
| Offshore | (2.6) | (2.3) | (0.8) | 1.7 |
| Blended | 3.5 | 8.0 | (1.3) | 1.1 |
| Total employees (#) | 54,216 | 64,557 | 75,987 | 88,076 |
| Employee additions | 3,475 | 10,341 | 11,430 | 12,090 |
| Utilization rate (%) | 79.6 | 80.1 | 78.6 | 79.5 |
| SG&A expense as % of revenues | 16.3 | 14.3 | 13.9 | 13.8 |
| Re/US\$ rate | 48.6 | 46.5 | 46.1 | 45.3 |

Source: Kotak Institutional Equities estimates

Exhibit 6: HCLT - quarterly balance sheet, June fiscal-year ends, US\$ mn

| | Sep-08 | Dec-08 | Mar-09 | Jun-09 | Sep-09 | Dec-09 | Mar-10 | Jun-10 |
|---|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Assets | | | | | | | | |
| Cash and cash equivalents | 65 | 146 | 104 | 88 | 74 | 73 | 74 | 101 |
| Accounts receivables, net | 448 | 545 | 521 | 565 | 633 | 592 | 638 | 657 |
| Investments (treasury) | 491 | 270 | 308 | 309 | 491 | 321 | 432 | 425 |
| Other current assets | 223 | 268 | 279 | 223 | 199 | 178 | 185 | 191 |
| Total current assets | 1,226 | 1,229 | 1,212 | 1,185 | 1,397 | 1,164 | 1,329 | 1,373 |
| Current liabilities | 549 | 728 | 741 | 682 | 655 | 648 | 649 | 675 |
| Net current assets | 677 | 501 | 471 | 503 | 742 | 516 | 680 | 698 |
| Net block | 301 | 313 | 324 | 331 | 339 | 362 | 391 | 398 |
| Goodwill and intangible assets | 232 | 900 | 858 | 946 | 945 | 973 | 944 | 929 |
| Other assets | 123 | 147 | 154 | 187 | 196 | 217 | 218 | 223 |
| Total assets | 1,333 | 1,861 | 1,808 | 1,968 | 2,222 | 2,068 | 2,234 | 2,248 |
| Liabilities and stockholder's equity | | | | | | | | |
| Borrowings | — | 636 | 680 | 622 | 786 | 534 | 621 | 574 |
| Other long-term liabilities | 180 | 184 | 149 | 159 | 182 | 169 | 149 | 159 |
| Total liabilities | 180 | 820 | 829 | 781 | 968 | 703 | 770 | 733 |
| Minority interest | 1 | 1 | 1 | — | — | — | — | — |
| Total stockholder's equity | 1,152 | 1,041 | 978 | 1,187 | 1,253 | 1,364 | 1,463 | 1,515 |
| Total liabilities and stockholder's equity | 1,333 | 1,861 | 1,808 | 1,968 | 2,222 | 2,068 | 2,234 | 2,248 |

Source: Company, Kotak Institutional Equities

Exhibit 7: Consolidated financials for HCL Technologies, 2008-2012E, June fiscal year-ends (Rs mn)

| | 2008 | 2009 | 2010 | 2011E | 2012E |
|---|---------------|----------------|----------------|----------------|----------------|
| Profit model | | | | | |
| Revenues | 76,394 | 106,301 | 125,650 | 153,552 | 180,666 |
| EBITDA | 16,159 | 22,778 | 24,779 | 27,627 | 32,720 |
| Depreciation (incl amortization of intangibles) | (3,033) | (4,465) | (5,006) | (5,323) | (5,893) |
| Other income | (1,195) | (3,629) | (5,278) | (715) | 577 |
| Pretax profits | 11,931 | 14,684 | 14,496 | 21,589 | 27,404 |
| Tax | (1,281) | (2,551) | (2,402) | (4,695) | (6,628) |
| Profit after tax | 10,650 | 12,133 | 12,094 | 16,894 | 20,776 |
| Diluted earnings per share (Rs) | 15.3 | 17.5 | 17.5 | 24.5 | 30.1 |
| Balance sheet | | | | | |
| Total equity | 49,296 | 57,657 | 70,382 | 83,479 | 95,991 |
| Deferred taxation liability | 184 | 2,194 | 2,098 | 2,081 | 2,044 |
| Total borrowings | 258 | 30,197 | 24,229 | 19,425 | 14,549 |
| Minority interest | 53 | 17 | 16 | 16 | 16 |
| Other non-current liabilities | 5,496 | 6,066 | 5,277 | 9,189 | 10,654 |
| Current liabilities | 20,613 | 32,625 | 33,766 | 35,695 | 40,476 |
| Total liabilities and equity | 75,901 | 128,757 | 135,769 | 149,886 | 163,730 |
| Cash | 9,500 | 19,031 | 16,604 | 19,376 | 23,052 |
| Other current assets | 26,127 | 38,323 | 39,359 | 50,279 | 57,646 |
| Goodwill and intangible assets | 9,055 | 45,974 | 43,141 | 42,134 | 40,829 |
| Tangible fixed assets | 12,582 | 16,089 | 18,495 | 22,189 | 25,807 |
| Investments | 13,853 | 609 | 8,525 | 7,959 | 7,815 |
| Other non-current assets | 4,784 | 8,732 | 9,645 | 7,949 | 8,582 |
| Total assets | 75,901 | 128,757 | 135,769 | 149,886 | 163,730 |
| Free cash flow | | | | | |
| Operating cash flow, excl. working capital | 15,453 | 19,956 | 27,437 | 22,932 | 24,181 |
| Working capital changes | (1,957) | (697) | (1,964) | (3,464) | (1,994) |
| Capital expenditure | (5,566) | (5,473) | (6,119) | (8,507) | (9,369) |
| Investment changes/acquisition | 2,477 | (18,203) | (7,943) | 498 | — |
| Other income | (1,195) | (3,629) | (5,278) | (715) | 577 |
| Free cash flow | 9,212 | (8,045) | 6,134 | 10,743 | 13,395 |
| Ratios (%) | | | | | |
| EBITDA margin | 21.2 | 21.4 | 19.7 | 18.0 | 18.1 |
| EBIT margin | 17.2 | 17.2 | 15.7 | 14.5 | 14.8 |
| Debt/equity | 0.0 | 0.5 | 0.3 | 0.2 | 0.2 |
| Net debt/equity | (0.5) | 0.2 | (0.0) | (0.1) | (0.2) |

Source: Company, Kotak Institutional Equities estimates

Exhibit 8: HCL Tech: Quarterly metrics

| | Mar-08 | Jun-08 | Sep-08 | Dec-08 | Mar-09 | Jun-09 | Sep-09 | Dec-09 | Mar-10 | Jun-10 |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Revenues (US\$ mn) | 484.9 | 504.0 | 504.7 | 511.5 | 564.5 | 607.2 | 630.1 | 651.7 | 685.2 | 737.6 |
| Revenues (Rs mn) | 19,448 | 21,688 | 23,693 | 24,908 | 28,615 | 29,085 | 30,314 | 30,325 | 30,757 | 34,254 |
| Exchange rate | 40.1 | 43.0 | 46.9 | 48.7 | 50.7 | 47.9 | 48.1 | 46.5 | 44.9 | 46.4 |
| Geographical mix | | | | | | | | | | |
| US | 55.9 | 57.4 | 57.3 | 59.8 | 61.0 | 58.9 | 58.7 | 57.0 | 59.5 | 61.5 |
| Europe | 29.6 | 29.1 | 28.7 | 27.1 | 27.6 | 28.5 | 29.0 | 29.5 | 26.7 | 24.6 |
| Asia Pacific | 14.5 | 13.5 | 14.0 | 13.1 | 11.4 | 12.6 | 12.3 | 13.5 | 13.8 | 13.9 |
| Revenues by service offering | | | | | | | | | | |
| Enterprise application services | 37.5 | 36.2 | 35.8 | 32.9 | 37.3 | 23.6 | 21.9 | 22.4 | 21.4 | 22.2 |
| Engineering and R&D services | 25.4 | 26.7 | 26.3 | 25.7 | 25.4 | 19.4 | 18.7 | 18.0 | 19.0 | 19.6 |
| Custom application (Industry solutions) | 10.7 | 10.8 | 10.9 | 12.5 | 10.6 | 29.7 | 30.7 | 30.5 | 29.9 | 29.6 |
| Infrastructure services | 14.8 | 15.1 | 15.7 | 16.5 | 15.0 | 17.6 | 19.4 | 20.3 | 22.2 | 22.4 |
| BPO services | 11.6 | 11.2 | 11.3 | 12.4 | 11.7 | 9.7 | 9.3 | 8.8 | 7.6 | 6.2 |
| Revenue by contract type | | | | | | | | | | |
| Time and Material | 65.0 | 65.0 | 64.0 | 63.8 | 62.4 | 61.5 | 60.0 | 60.4 | 59.5 | 59.1 |
| Fixed price | 35.0 | 35.0 | 36.0 | 36.2 | 37.6 | 38.5 | 40.0 | 39.6 | 40.5 | 40.9 |
| Revenue by vertical | | | | | | | | | | |
| Financial services | 28.3 | 27.3 | 27.5 | 27.7 | 23.6 | 24.8 | 26.3 | 26.1 | 25.5 | 24.9 |
| Manufacturing | 29.5 | 30.6 | 30.8 | 30.0 | 30.3 | 30.9 | 27.4 | 25.6 | 26.7 | 27.3 |
| Telecom | 16.4 | 16.0 | 16.4 | 15.8 | 12.1 | 12.5 | 13.0 | 12.5 | 11.6 | 10.9 |
| Retail & CPG | 8.4 | 8.8 | 8.2 | 7.7 | 6.9 | 6.6 | 7.0 | 8.0 | 7.5 | 8.2 |
| Media Publishing and entertainment | 5.7 | 5.6 | 5.6 | 5.5 | 5.0 | 5.6 | 6.8 | 7.2 | 7.9 | 7.4 |
| Life sciences | 5.5 | 5.7 | 5.9 | 5.9 | 6.3 | 6.4 | 6.4 | 7.2 | 7.5 | 8.2 |
| Energy-utilities-public sector | 1.5 | 1.5 | 1.4 | 3.2 | 8.9 | 7.6 | 6.8 | 7.3 | 7.0 | 6.9 |
| Others | 4.7 | 4.5 | 4.2 | 4.2 | 6.9 | 5.6 | 6.3 | 6.1 | 6.3 | 6.2 |
| Client metrics (LTM) | | | | | | | | | | |
| Active client relationships | 269 | 279 | 295 | 315 | 353 | 367 | 373 | 399 | 404 | 408 |
| New client relationships | 32 | 30 | 29 | 26 | 68 | 37 | 28 | 36 | 39 | 51 |
| Number of million dollar clients (LTM) | | | | | | | | | | |
| 100 Million dollar + | 2 | 2 | 2 | 2 | 2 | 2 | 1 | 1 | 1 | 1 |
| 50 Million dollar + | 3 | 3 | 3 | 4 | 4 | 4 | 4 | 4 | 5 | 5 |
| 40 Million dollar + | 6 | 8 | 8 | 8 | 7 | 7 | 7 | 7 | 7 | 7 |
| 30 Million dollar + | 11 | 12 | 12 | 12 | 11 | 8 | 9 | 9 | 10 | 12 |
| 20 Million dollar + | 15 | 16 | 17 | 19 | 19 | 20 | 20 | 21 | 22 | 24 |
| 10 Million dollar + | 31 | 34 | 36 | 39 | 40 | 43 | 45 | 51 | 55 | 58 |
| 5 Million dollar + | 64 | 66 | 68 | 68 | 81 | 85 | 94 | 104 | 106 | 107 |
| 1 Million dollar + | 186 | 201 | 205 | 218 | 256 | 253 | 264 | 281 | 281 | 283 |
| Client contribution to revenue | | | | | | | | | | |
| Top 5 clients | 27.5 | 26.7 | 26.1 | 25.3 | 22.7 | 20.6 | 19.0 | 18.0 | 17.8 | 17.7 |
| Top 10 clients | 38.2 | 37.3 | 36.6 | 35.1 | 31.9 | 28.9 | 27.2 | 26.2 | 25.8 | 25.9 |
| Top 20 clients | 50.6 | 49.6 | 48.8 | 47.9 | 43.6 | 40.2 | 38.1 | 36.9 | 36.6 | 36.6 |
| Repeat business | 94.5 | 94.0 | 92.9 | 90.9 | 90.0 | 88.4 | 93.7 | 94.4 | 93.4 | 91.9 |
| Days sales outstanding | 77 | 79 | 80 | 82 | 83 | 84 | 90 | 82 | 84 | 80 |
| Operational metrics - Software services | | | | | | | | | | |
| Effort mix | | | | | | | | | | |
| Onsite | 75.0 | 74.7 | 74.9 | 75.3 | 71.6 | 71.7 | 71.9 | 71.5 | 72.2 | 72.1 |
| Offshore | 25.0 | 25.3 | 25.1 | 24.7 | 28.4 | 28.3 | 28.1 | 28.5 | 27.8 | 27.9 |
| Revenue mix | | | | | | | | | | |
| Onsite | 50.7 | 50.2 | 52.0 | 53.5 | 41.1 | 41.2 | 41.5 | 40.9 | 41.3 | 41.4 |
| Offshore | 49.3 | 49.8 | 48.0 | 46.5 | 58.9 | 58.8 | 58.5 | 59.1 | 58.7 | 58.6 |
| Utilization | | | | | | | | | | |
| Offshore - Including trainees | 71.3 | 73.9 | 74.4 | 74.5 | 74.1 | 76.2 | 76.0 | 76.4 | 76.2 | 72.9 |
| Onsite | 95.1 | 96.8 | 96.5 | 97.4 | 96.4 | 97.0 | 97.2 | 96.7 | 95.6 | 95.2 |
| Efforts Billed - Offshore | 47,263 | 48,957 | 49,603 | 50,419 | 50,539 | 50,640 | 51,167 | 51,530 | 55,769 | 61,518 |
| Efforts Billed - Onsite | 15,781 | 16,608 | 16,644 | 16,565 | 20,049 | 20,022 | 19,950 | 20,504 | 21,447 | 23,777 |
| Total Billed Efforts | 63,044 | 65,565 | 66,247 | 66,984 | 70,588 | 70,662 | 71,117 | 72,034 | 77,216 | 85,295 |
| Consolidated manpower | 49,802 | 50,741 | 52,714 | 55,018 | 54,026 | 54,216 | 54,443 | 55,688 | 58,129 | 64,557 |
| Software services - total | 30,387 | 30,391 | 31,271 | 33,298 | 32,902 | 32,364 | 32,312 | 33,455 | 36,169 | 41,113 |
| Gross addition | 1,026 | 1,792 | 2,007 | 1,275 | 622 | 844 | 1,520 | 2,595 | 4,639 | 7,088 |
| Net addition | (97) | 4 | 880 | 2,027 | (396) | (538) | (52) | 1,143 | 2,714 | 4,944 |
| Gross lateral employee addition | 1,013 | 1,580 | 1,767 | 922 | 596 | 322 | 1,063 | 1,989 | 3,882 | 5,742 |
| Attrition - LTM | 15.2 | 14.8 | 14.2 | 13.4 | 13.1 | 12.9 | 12.7 | 12.9 | 14.1 | 15.5 |
| Infrastructure services - total | 6,176 | 7,035 | 8,279 | 8,970 | 9,698 | 10,522 | 10,769 | 11,317 | 11,755 | 12,220 |
| Gross addition | 947 | 1,102 | 1,462 | 941 | 956 | 509 | 1,092 | 995 | 1,091 | 1,205 |
| Attrition - LTM | 15.4 | 14.9 | 14.3 | 13.5 | 13.5 | 13.2 | 13.2 | 12.6 | 13.2 | 16.0 |
| BPO services - total | 13,239 | 13,315 | 13,164 | 12,750 | 11,426 | 11,800 | 11,362 | 10,916 | 10,205 | 11,224 |
| Gross addition | 3,342 | 2,423 | 2,128 | 1,731 | 720 | 2,038 | 1,710 | 1,939 | 1,406 | 3,295 |
| Gross lateral employee addition | 1,217 | 1,234 | 502 | 556 | 160 | 662 | 424 | 692 | 560 | 1,297 |
| Offshore attrition - quarterly | 12.0 | 12.3 | 16.0 | 12.7 | 14.8 | 12.6 | 17.4 | 21.0 | 20.3 | 15.3 |

Source: Company

JULY 29, 2010
RESULT

 Coverage view: **Attractive**

 Price (Rs): **721**

 Target price (Rs): **635**

 BSE-30: **17,992**
Results disappoint; adjusting margins for large forex loss may not be justified.

Siemens reported revenues of Rs22 bn, 5.5% below estimates, but recorded a strong 17% growth. Margins (at 10.8%, down 260 bps) impacted by forex losses likely due to forward contracts on Euro to hedge for raw material payments; we are disinclined to look at adjusted margins. Industrial segment continues on its strong growth path and power segment also reported a strong growth versus decline in 1H. Reiterate REDUCE.

Company data and valuation summary

Siemens

| Stock data | | | | Forecasts/Valuations | | | |
|-------------------------------|---------|-------|------|----------------------|-------|-------|-------|
| 52-week range (Rs) (high,low) | 766-420 | | | EPS (Rs) | 2010 | 2011E | 2012E |
| Market Cap. (Rs bn) | 243.1 | | | EPS growth (%) | 59.1 | 7.6 | 18.4 |
| Shareholding pattern (%) | | | | P/E (X) | 28.2 | 26.2 | 22.1 |
| Promoters | 55.2 | | | Sales (Rs bn) | 100.0 | 117.8 | 138.6 |
| FIs | 3.6 | | | Net profits (Rs bn) | 8.6 | 9.3 | 11.0 |
| MFs | 5.6 | | | EBITDA (Rs bn) | 12.6 | 13.5 | 15.7 |
| Price performance (%) | | | | EV/EBITDA (X) | 17.4 | 15.8 | 13.0 |
| Absolute | 1M | 3M | 12M | ROE (%) | 28.0 | 24.6 | 24.1 |
| Rel. to BSE-30 | (1.4) | 1.9 | 50.9 | Div. Yield (%) | 0.7 | 0.8 | 0.9 |
| | (3.9) | (0.9) | 27.3 | | | | |

Revenues disappoint slightly; forex losses adversely impact margins - disinclined to adjust for it

Siemens reported 3QFY10 (fiscal year-ends September 30, 2010) revenues of Rs22.5 bn, up 17% on a yoy, about 5.5% below our estimates. EBITDA margin at 10.8%, down 260 bps yoy, was impacted by forex losses of Rs670 mn (also reflected in higher other expenses). We believe exchange losses were potentially from forward contracts (Buy Euro contracts to hedge payments for raw materials) as Euro has depreciated; we are disinclined to adjust and then look at margins. The lower-than-expected revenues and margins led to a PAT of Rs1.6 bn, 16% below our estimate and 19.7% down on a yoy basis.

Industrial segment continues strong growth path; power reports strong growth vs decline so far

The industrial segment continued on its strong growth path in line with the trend seen in the past few quarters, recording a 28% yoy growth in revenues. The power segment also recorded a strong growth of 23% yoy versus a decline in 1HFY10; growth was led by the power transmission segment (revenues up 39.4% yoy). Power transmission segment margins moderated versus high levels of 20-22% in previous quarters; however, still remains high at 13.7%.

Moderate order inflows; backlog remains relatively flat on a sequential basis

Siemens reported moderate order inflows of Rs20.1 bn in 3QFY10, about 14% down on a yoy basis - broadly in line with the FY2008-09 quarterly average levels of about Rs20-22 bn. The company has also recently won a turnkey order for two combined cycle power plants for Torrent Group. The 9MFY10-end backlog of Rs135.5 bn, up 33.6% yoy, was primarily led by the single large order worth Rs25 bn won in 1QFY10 from the Qatar General Electricity & Water Corporation.

Revise estimates; reiterate REDUCE with a target price of Rs635/share

We revise our earnings estimates to Rs25.6 and Rs27.5 from Rs27.4 and Rs 29.4 earlier for y/e Sept 2010E and 2011E, respectively. We have retained our target of Rs635 as change in earnings is offset by shift to March-12E based valuation. We reiterate our REDUCE rating based on (1) high valuations unjustifiable given volatile nature of performance, (2) difficulty in judging core performance with one-offs and (3) weak pricing environment led by increased competition.

Lokesh Garg
lokesh.garg@kotak.com
Mumbai: +91-22-6634-1496

Supriya Subramanian
supriya.subramanian@kotak.com
Mumbai: +91-22-6634-1383

Nitij Mangal
nitij.mangal@kotak.com
Mumbai: +91-22-6634-1453

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Revenues disappoint slightly; forex losses adversely impact margins in 3QFY10

Siemens reported 3QFY10 (fiscal year-ends September 30, 2010) revenues of Rs22.5 bn, up 17% on a yoy basis from Rs23.8 bn in 3QFY09. This was about 5.5% below our estimates of Rs23.8 bn. EBITDA margin at 10.8% in 3QFY10 was about 120 bps below our estimate of 12% and about 260 bps down on a yoy basis. The lower-than-expected revenues and margins led to a PAT of Rs1.6 bn, 16% below our estimate and 19.7% down on a yoy basis.

For the nine months ended June 30, 2010, Siemens reported a moderate revenue growth of 6.7%, to Rs63.4 bn. Margins expanded by about 100 bps to 14.1% from 13.1% in 9MFY09. The PAT for the two periods are not comparable as the previous year includes dividend income of Rs2.2 bn from SISL and SIPS.

Forex loss potentially from forward contracts; disinclined to look at adjusted margins

The yoy decline in margin for the quarter was primarily led by forex losses of about Rs670 mn, which was absent in the quarter of the previous year. The company reported forex losses of Rs1.83 bn in 9MFY10 versus marginal gain of Rs24 mn in 9MFY09. This is also reflected in higher other expenses as a percentage of sales which increased by 250 bps yoy to 10.2% in 3QFY10 versus 7.7% in 3QFY09.

We believe exchange losses are arising on Buy Euro contracts that Siemens may have taken to hedge its raw material imports. Siemens imports 45% of its raw material requirements which implies an import of about Rs30 bn during FY2010. On this quantity of imports, hedging Euro contracts may have led to losses of Rs1.8 bn (for about 10% depreciation in Euro). However we believe a similar benefit would have accrued in the form of lower raw material costs and thus at EBITDA level it might not have a significant impact. Only MTM losses where in underlying transaction has not closed as yet, deserve adjustment in EBITDA for looking at organic EBITDA margins.

Revenues disappoint marginally; margins impacted by forex losses

Siemens (standalone) - 3Q10 - key numbers, year ending September 30, 2010 (Rs mn)

| | 3Q10 | 3Q10E | 3Q09 | 2Q10 | % change | | | 9MFY10 | 9MFY09 | % change |
|---------------------------|-----------------|-----------------|-----------------|-----------------|---------------|---------------|---------------|-----------------|-----------------|---------------|
| | | | | | 3Q10E | 3Q09 | 2Q10 | | | |
| Sales | 22,464 | 23,776 | 19,177 | 22,261 | (5.5) | 17.1 | 0.9 | 63,391 | 59,405 | 6.7 |
| Expenses | (20,044) | (20,923) | (16,606) | (19,400) | (4.2) | 20.7 | 3.3 | (54,477) | (51,643) | 5.5 |
| Stock | 3,029 | | 996 | 648 | | 204.1 | 367.2 | 5,995 | 1,582 | |
| Raw material | (19,085) | | (14,706) | (16,566) | | 29.8 | 15.2 | (50,417) | (45,733) | 10.2 |
| Employee | (1,703) | | (1,428) | (1,530) | | 19.3 | 11.3 | (4,524) | (3,912) | 15.6 |
| Other Exp | (2,284) | | (1,467) | (1,951) | | 55.7 | 17.1 | (5,531) | (3,580) | 54.5 |
| EBITDA | 2,420 | 2,853 | 2,571 | 2,861 | (15.2) | (5.9) | (15.4) | 8,914 | 7,762 | 14.8 |
| Interest | 181 | 150 | 118 | 117 | 20.4 | 52.5 | 54.1 | 455 | 377 | 20.5 |
| Depreciation | (249) | (219) | (199) | (237) | 14.0 | 25.1 | 5.1 | (698) | (565) | 23.7 |
| PBT | 2,351 | 2,816 | 2,568 | 2,741 | (16.5) | (8.5) | (14.2) | 8,671 | 9,916 | (12.6) |
| Tax | (790) | (957) | (624) | (930) | (17.5) | 26.5 | (15.1) | (2,933) | (2,411) | 21.7 |
| Net profit | 1,561 | 1,858 | 1,944 | 1,811 | (16.0) | (19.7) | (13.8) | 5,737 | 7,505 | (23.5) |
| Key ratios (%) | | | | | | | | | | |
| Raw material / Sales | 71.5 | | 71.5 | 71.5 | | | | 70.1 | 74.3 | |
| Employee expenses / Sales | 7.6 | | 7.4 | 6.9 | | | | 7.1 | 6.6 | |
| Other expenses / Sales | 10.2 | | 7.7 | 8.8 | | | | 8.7 | 6.0 | |
| EBITDA margin | 10.8 | 12.0 | 13.4 | 12.9 | | | | 14.1 | 13.1 | |
| PBT margin | 10.5 | 11.8 | 13.4 | 12.3 | | | | 13.7 | 16.7 | |
| PAT margin | 6.9 | 7.8 | 10.1 | 8.1 | | | | 9.1 | 12.6 | |
| Order details | | | | | | | | | | |
| Order booking | 20,070 | | 23,400 | 22,380 | | (14.2) | (10.3) | 94,130 | 61,791 | 52.3 |
| Order backlog | 135,540 | | 101,450 | 134,450 | | 33.6 | 0.8 | 135,540 | 101,450 | 33.6 |

Source: Company, Kotak Institutional Equities estimates

Industrial retains growth trend; power reports strong growth vs decline so far

Both the industry and power segments recorded very strong revenue growth in the quarter. The industry segment (comprising of Industry Automation, drive technologies, building technologies and Industry Solutions) recorded a 28.4% yoy growth in revenues to Rs9 bn from Rs7 bn in 3QFY09. This is inline with the trend seen in the past few quarters as well as the trend of the industry and product segments of other companies such as Crompton, L&T etc. The company has also cited a strong uptick in the short cycle business leading to the strong growth in this segment.

The power segment of Siemens also recorded a strong revenue growth of 23.3% to Rs12.1 bn in 3QFY10 from Rs9.8 bn in 3QFY09. The slowdown seen in the power transmission segment in the past few quarter reversed in 3QFY10. The power transmission segment recorded a very strong revenue growth of 39.4% yoy; this is versus a 22% decline seen in 1HFY10. The oil & gas segment also recorded a very strong growth in revenues of 29.6% yoy. The power distribution segment reported a moderate yoy growth of 4% in this quarter.

Power T&D margins moderated to 14% this quarter from 20-22% over last few quarters; though still high

Power segment margins recorded a decline to 10.6% in 3QFY10 versus 16.9% in 3QFY09 and 16.4% in the previous quarter. The margin decline was led by the power transmission segment which recorded a 830 bps yoy decline in EBIT margins. Power Transmission margins moderated to 13.7% this quarter versus very high margins of about 20-22% over last few quarters; however, we still believe that these margins are relatively high. Margins for the industry segment remained relatively flat on a yoy basis.

Segmental revenues and margins of Siemens for 3Q10, year ending September 30, 2010 (Rs mn)

| | 3Q10 | 3Q09 | 2Q10 | % change | | 9MFY10 | 9MFY09 | % change |
|---|---------------|--------------|---------------|---------------|---------------|---------------|---------------|--------------|
| | | | | 3Q09 | 2Q10 | | | |
| Revenues | | | | | | | | |
| Industrial | 9,039 | 7,039 | 9,944 | 28.4 | (9.1) | 26,964 | 21,900 | 23.1 |
| Industry Automation & Drives + Bldg solns | 6,116 | 4,708 | 6,851 | 29.9 | (10.7) | 18,582 | 14,826 | 25.3 |
| Industry Solutions | 2,923 | 2,331 | 3,093 | 25.4 | (5.5) | 8,382 | 7,074 | 18.5 |
| Power | 12,108 | 9,824 | 10,158 | 23.3 | 19.2 | 30,743 | 31,792 | (3.3) |
| Fossil Power Generation | 255 | 750 | 284 | (66.0) | (10.0) | 822 | 2,475 | (66.8) |
| Oil and Gas | 1,677 | 1,294 | 1,656 | 29.6 | 1.2 | 4,890 | 3,634 | 34.6 |
| Power Transmission | 8,196 | 5,879 | 5,902 | 39.4 | 38.9 | 18,826 | 19,518 | (3.5) |
| Power Distribution | 1,980 | 1,901 | 2,316 | 4.2 | (14.5) | 6,205 | 6,166 | 0.6 |
| Others | 3,828 | 4,030 | 4,620 | (5.0) | (17.1) | 13,052 | 11,341 | 15.1 |
| Mobility | 1,777 | 2,742 | 2,812 | (35.2) | (36.8) | 7,715 | 7,325 | 5.3 |
| Healthcare | 1,926 | 1,137 | 1,678 | 69.4 | 14.8 | 4,924 | 3,530 | 39.5 |
| Real estate | 124 | 151 | 131 | (17.7) | (4.8) | 414 | 486 | (14.9) |
| PBIT | | | | | | | | |
| Industrial | 584 | 478 | 480 | 22.2 | 21.8 | 1,923 | 1,638 | 17.4 |
| Industry Automation & Drives + Bldg solns | 220 | 308 | 227 | (28.6) | (3.1) | 1,132 | 970 | 16.8 |
| Industry Solutions | 364 | 169 | 252 | 114.6 | 44.2 | 791 | 668 | 18.4 |
| Power | 1,285 | 1,656 | 1,662 | (22.4) | (22.7) | 4,833 | 5,190 | (6.9) |
| Fossil Power Generation | 5 | 93 | 165 | (94.5) | (96.9) | 298 | 211 | 41.4 |
| Oil and Gas | 20 | 237 | 139 | (91.6) | (85.7) | 438 | 588 | (25.5) |
| Power Transmission | 1,126 | 1,297 | 1,167 | (13.2) | (3.5) | 3,610 | 3,953 | (8.7) |
| Power Distribution | 135 | 29 | 191 | 359.5 | (29.4) | 487 | 438 | 11.2 |
| Others | 226 | 171 | 171 | 32.7 | 32.4 | 807 | 543 | 48.7 |
| Mobility | 74 | 102 | 311 | (26.8) | (76.1) | 651 | (39) | (1,764.1) |
| Healthcare | 127 | (4) | 73 | (3,168.3) | 72.3 | 261 | 92 | 183.5 |
| Real estate | 100 | 175 | 98 | (42.8) | 2.4 | 546 | 451 | 21.1 |
| EBIT Margin | | | | | | | | |
| Industrial | 6.5 | 6.8 | 4.8 | | | 7.1 | 7.5 | |
| Industry Automation & Drives + Bldg solns | 3.6 | 6.6 | 3.3 | | | 6.1 | 6.5 | |
| Industry Solutions | 12.4 | 7.3 | 8.2 | | | 9.4 | 9.4 | |
| Power | 10.6 | 16.9 | 16.4 | | | 15.7 | 16.3 | |
| Fossil Power Generation | 2.0 | 12.4 | 58.2 | | | 36.2 | 8.5 | |
| Oil and Gas | 1.2 | 18.3 | 8.4 | | | 9.0 | 16.2 | |
| Power Transmission | 13.7 | 22.1 | 19.8 | | | 19.2 | 20.3 | |
| Power Distribution | 6.8 | 1.5 | 8.2 | | | 7.8 | 7.1 | |
| Others | 5.9 | 4.2 | 3.7 | | | 6.2 | 4.8 | |
| Mobility | 4.2 | 3.7 | 11.1 | | | 8.4 | (0.5) | |
| Healthcare | 6.6 | (0.4) | 4.4 | | | 5.3 | 2.6 | |
| Real estate | 80.4 | 115.8 | 74.7 | | | 131.9 | 92.7 | |

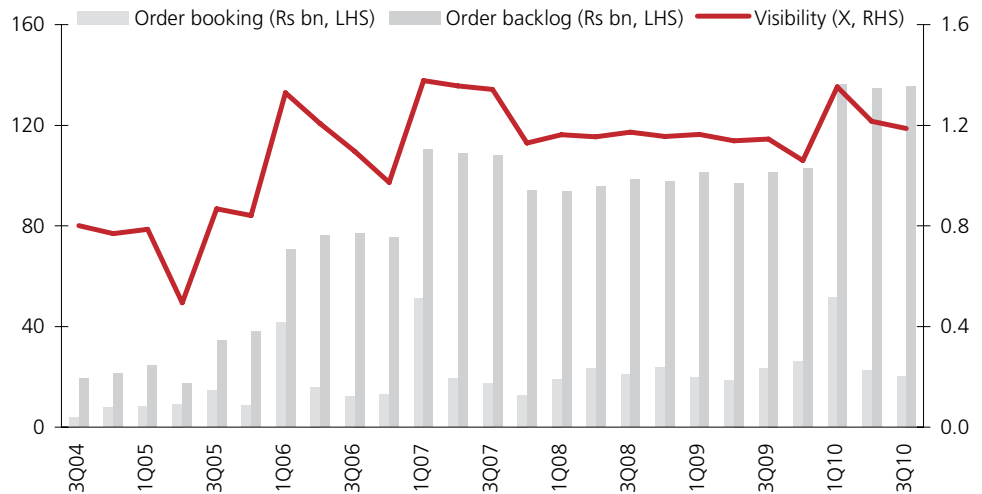
Source: Company, Kotak Institutional Equities estimates

Moderate order inflows; backlog remains relatively flat on a sequential basis

Siemens reported moderate order inflows of Rs20.1 bn in 3QFY10, about 14% down on a yoy basis. The order inflow for the quarter was broadly in line with the FY2008-09 quarterly average levels of about Rs20-22 bn. The inflows for the quarter were led by the turnkey order for two combined cycle power plants for Torrent Group. The company reported a 9MFY10-end backlog of Rs135.5 bn, relatively flat on a sequential basis (was Rs134.5 bn at end-1HFY10). The order backlog was up 33.6% on a yoy basis primarily led by the single large order worth Rs25 bn won in 1QFY10 from the Qatar General Electricity & Water Corporation. The order backlog provides Siemens with a revenue visibility of about 1.2 years based on forward four quarter revenues.

Visibility maintained at about 1.2 years at the end of June 2010

Order booking, order backlog & visibility trend for Siemens, September fiscal year-ends



Source: Company, Kotak Institutional Equities estimates

Full-year estimates imply strong performance in 4QFY10

Our full-year revenue estimate of Rs97 bn (up 14.5% yoy) implies a strong revenue growth of 33% in 4QFY10E to Rs33.5 bn. We believe that this growth is likely to be led by positive traction in the industry and power segments and partially led by low base effects of 4QFY09. We expect the company to record full-year EBITDA margin of 13% versus 14.1% recorded in 9MFY10 so far. This would imply margins of about 10.3% in 4QFY10. The implied margin and PAT levels in 4QFY10E are not comparable to those of the previous year as 4QFY09 margins were impacted by project-related one-offs in the industry and power segments.

Siemens (standalone) - 4QFY10E implied numbers, year ending September 30, 2010 (Rs mn)

| | 9MFY10 | 9MFY09 | % change | 4QFY10-implied | 4QFY09 | % change | FY2010E | FY2009 | % change |
|-----------------------|---------------|---------------|---------------|----------------|---------------|--------------|---------------|---------------|-------------|
| Sales | 63,391 | 59,405 | 6.7 | 33,704 | 25,180 | 33.9 | 97,095 | 84,585 | 14.8 |
| Expenses | (54,477) | (51,643) | 5.5 | (30,242) | (22,710) | 33.2 | (84,719) | (74,353) | 13.9 |
| EBITDA | 8,914 | 7,762 | 14.8 | 3,462 | 2,470 | 40.2 | 12,376 | 10,232 | 21.0 |
| Interest | 455 | 377 | 20.5 | 775 | 87 | 793.6 | 1,230 | 464 | 165.0 |
| Depreciation | (698) | (565) | 23.7 | (214) | (213) | 0.1 | (912) | (778) | 17.2 |
| PBT | 8,671 | 9,916 | (12.6) | 4,129 | 2,343 | 76.2 | 12,799 | 12,259 | 4.4 |
| Tax | (2,933) | (2,411) | 21.7 | (1,316) | (1,459) | (9.8) | (4,249) | (3,870) | 9.8 |
| Net profit | 5,737 | 7,505 | (23.5) | 2,813 | 885 | 218.0 | 8,550 | 8,389 | 1.9 |
| Key ratios (%) | | | | | | | | | |
| EBITDA margin | 14.1 | 13.1 | | 10.3 | 9.8 | | 12.7 | 12.1 | |
| PBT margin | 13.7 | 16.7 | | 12.2 | 9.3 | | 13.2 | 14.5 | |
| PAT margin | 9.1 | 12.6 | | 8.3 | 3.5 | | 8.8 | 9.9 | |

Source: Company, Kotak Institutional Equities estimates

The implied growth of 33% in 4QFY10 is likely to be led by both the power and industry segments. We expect the power segment to record a 24% yoy growth in revenues and the industry segment to record a 25% growth in revenues in 4QFY10.

Segmental revenues of Siemens, September fiscal year-ends, 2008-12E (Rs mn)

| | 2008 | 2009 | 9MFY10 | 4QFY10E | 2010E | 2011E | 2012E |
|--------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Industry | 33,078 | 33,652 | 26,964 | 14,702 | 41,665 | 49,998 | 59,998 |
| % growth | 26.8 | 1.7 | 23.1 | 25.1 | 23.8 | 20.0 | 20.0 |
| EBIT | 3,334 | 2,630 | 1,923 | 1,251 | 3,175 | 4,238 | 5,086 |
| EBIT Margin | 10.1 | 7.8 | 7.1 | 8.5 | 7.6 | 8.5 | 8.5 |
| Power | 42,378 | 43,420 | 30,743 | 14,413 | 45,156 | 53,285 | 62,876 |
| % growth | (1.5) | 2.5 | (3.3) | 24.0 | 4.0 | 18.0 | 18.0 |
| EBIT | 3,070 | 5,911 | 4,833 | 1,489 | 6,322 | 5,861 | 6,916 |
| EBIT Margin | 7.2 | 13.6 | 15.7 | 10.3 | 14.0 | 11.0 | 11.0 |
| Transport | 6,709 | 10,260 | 7,715 | 2,854 | 10,568 | 11,625 | 12,787 |
| % growth | 93.5 | 52.9 | 5.3 | (2.8) | 3.0 | 10.0 | 10.0 |
| EBIT | (205) | (77) | 651 | 247 | 898 | 1,046 | 1,151 |
| EBIT Margin | (3.0) | (0.7) | 8.4 | 8.7 | 8.5 | 9.0 | 9.0 |
| Healthcare | 6,053 | 5,431 | 4,924 | 2,408 | 7,332 | 8,798 | 10,118 |
| % growth | 15.4 | (10.3) | 39.5 | 26.7 | 35.0 | 20.0 | 15.0 |
| EBIT | 333 | 413 | 261 | 142 | 403 | 484 | 556 |
| EBIT Margin | 5.5 | 7.6 | 5.3 | 5.9 | 5.5 | 5.5 | 5.5 |
| Real estate | 645 | 653 | 414 | 141 | 555 | 555 | 555 |
| % growth | 30.1 | 1.3 | (14.9) | (15.4) | (15.0) | — | — |
| EBIT | 614 | 844 | 546 | 120 | 666 | 555 | 555 |
| EBIT Margin | 95.3 | 129.3 | 131.9 | 85.2 | 120.0 | 100.0 | 100.0 |

Source: Company, Kotak Institutional Equities estimates

Revise earnings estimates, target price at Rs635/share; reiterate REDUCE

We have revised our earnings estimates to Rs25.6 and Rs27.5 from Rs27.4 and Rs 29.4 earlier for September year ending 2010E and 2011E, respectively. The revision in estimates in y/e September 2010 is based on slightly lower power segment revenues and industry segment margins based on reported numbers so far.

We have retained our target price at Rs635/share as the downward revision to earnings estimates was offset by move to 21X March-12E earnings based valuation from September-11E based valuation earlier. We believe that the high historical valuations at which the company has traded (one-year rolling forward P/E of about 25-26X) are not justifiable given the weaker demand and pricing environment.

Revised estimates for Siemens, September fiscal year-ends, 2010E-12E (Rs mn)

| | New estimates | | | Previous estimates | | | % revision | | |
|-----------------------|---------------|---------|---------|--------------------|---------|---------|------------|---------|---------|
| | FY2010E | FY2011E | FY2012E | FY2010E | FY2011E | FY2012E | FY2010E | FY2011E | FY2012E |
| Revenues | 99,953 | 117,839 | 138,626 | 101,922 | 119,436 | 139,619 | (1.9) | (1.3) | (0.7) |
| EBITDA | 12,564 | 13,487 | 15,748 | 13,432 | 14,455 | 16,792 | (6.5) | (6.7) | (6.2) |
| EBITDA margin | 12.6 | 11.4 | 11.4 | 13.2 | 12.1 | 12.0 | | | |
| PBT | 12,917 | 13,893 | 16,442 | 13,821 | 14,856 | 17,482 | (6.5) | (6.5) | (5.9) |
| PAT | 8,628 | 9,280 | 10,983 | 9,233 | 9,924 | 11,678 | (6.5) | (6.5) | (5.9) |
| EPS (Rs) | 25.6 | 27.5 | 32.6 | 27.4 | 29.4 | 34.6 | (6.5) | (6.5) | (5.9) |
| yoy growth (%) | | | | | | | | | |
| Revenues | 6.9 | 17.9 | 17.6 | 9.0 | 17.2 | 16.9 | | | |
| EBITDA | 19.5 | 7.4 | 16.8 | 27.7 | 7.6 | 16.2 | | | |
| PBT | 37.7 | 7.6 | 18.4 | 47.3 | 7.5 | 17.7 | | | |
| PAT | 22.5 | 7.6 | 18.4 | 31.0 | 7.5 | 17.7 | | | |
| EPS | 22.5 | 7.6 | 18.4 | 31.0 | 7.5 | 17.7 | | | |

Source: Kotak Institutional Equities estimates

We reiterate our REDUCE rating on the stock based on (1) high valuations unjustifiable given volatile nature of business performance, (2) incremental difficulty in judging the performance of the core business and (3) increasing competition in the power segment with competitors such as Areva, Crompton and Hyosung scaling up presence leading to market share as well as price challenge.

Key upside risks arise from better-than-expected order booking, revenue growth and margins leading to positive earnings surprise. Key downside risks arise from (1) repetition of problems witnessed in the earlier quarters in other orders and (2) residual dependence on large orders that potentially yield lower margins.

Siemens (consolidated) balance sheet, September fiscal year-ends, 2007-2011E (Rs mn)

| | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E |
|--------------------------------------|----------------|----------------|---------------|---------------|----------------|----------------|
| Income statement | | | | | | |
| Sales | 94,175 | 97,296 | 93,491 | 99,953 | 117,839 | 138,626 |
| Expenses | (84,338) | (88,193) | (82,976) | (87,389) | (104,352) | (122,878) |
| EBITDA | 9,837 | 9,103 | 10,515 | 12,564 | 13,487 | 15,748 |
| Other income | 761 | 821 | 115 | 1,356 | 1,522 | 1,962 |
| Interest | (45) | (46) | 485 | (21) | (21) | (21) |
| Depreciation | (1,403) | (1,617) | (1,733) | (982) | (1,096) | (1,246) |
| PBT | 9,149 | 8,262 | 9,382 | 12,917 | 13,893 | 16,442 |
| Tax | (3,007) | (3,483) | (3,960) | (4,288) | (4,612) | (5,459) |
| Net profit | 6,142 | 4,779 | 5,422 | 8,628 | 9,280 | 10,983 |
| Extraordinary items | 787 | 1,216 | 1,624 | — | — | — |
| RPAT | 6,940 | 5,995 | 7,046 | 8,628 | 9,280 | 10,983 |
| EPS (Rs) | 20.6 | 17.8 | 20.9 | 25.6 | 27.5 | 32.6 |
| Balance sheet | | | | | | |
| Equity share capital | 337 | 674 | 674 | 674 | 674 | 674 |
| Reserves & surplus | 17,964 | 22,100 | 27,139 | 33,766 | 40,907 | 49,358 |
| Shareholders funds | 18,301 | 22,774 | 27,813 | 34,441 | 41,582 | 50,032 |
| Minority Interest | 80 | 147 | 56 | 56 | 56 | 56 |
| Loan funds | 317 | 112 | 6 | 6 | 5 | 5 |
| Total sources of funds | 18,698 | 23,034 | 27,876 | 34,503 | 41,643 | 50,093 |
| Net block | 7,546 | 7,948 | 9,268 | 7,786 | 8,890 | 10,094 |
| CWIP | 1,103 | 1,068 | 1,616 | 1,616 | 1,616 | 1,616 |
| Net fixed assets | 8,649 | 9,016 | 10,885 | 9,402 | 10,507 | 11,710 |
| Investments | 1,943 | 2,450 | — | — | — | — |
| Cash balances | 8,570 | 13,222 | 14,746 | 24,307 | 30,242 | 37,898 |
| Net current assets excl. cash | (1,239) | (3,116) | 1,049 | (403) | (302) | (711) |
| Net deferred tax assets | 775 | 1,462 | 1,196 | 1,196 | 1,196 | 1,196 |
| Total assets | 18,698 | 23,034 | 27,876 | 34,503 | 41,643 | 50,093 |
| Key ratios (%) | | | | | | |
| EBITDA margin | 10.4 | 9.4 | 11.2 | 12.6 | 11.4 | 11.4 |
| PAT margin | 6.5 | 4.9 | 5.8 | 8.6 | 7.9 | 7.9 |
| RoE | 45.2 | 29.2 | 27.9 | 27.7 | 24.4 | 24.0 |
| RoCE | 35.4 | 19.9 | 106.5 | 25.6 | 22.7 | 22.5 |

Source: Company, Kotak Institutional Equities estimates

Siemens (standalone) financials, September fiscal year-ends, 2007-12E (Rs mn)

| | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E |
|--------------------------------------|---------------|----------------|---------------|---------------|----------------|----------------|
| Income statement | | | | | | |
| Sales | 77,660 | 83,577 | 84,585 | 97,095 | 114,543 | 134,824 |
| Expenses | (70,246) | (75,787) | (74,353) | (84,719) | (101,352) | (119,419) |
| EBITDA | 7,415 | 7,791 | 10,232 | 12,376 | 13,191 | 15,405 |
| Other income | 1,038 | 539 | 2,864 | 1,356 | 1,522 | 1,962 |
| Interest | (2) | (21) | (59) | (21) | (21) | (21) |
| Depreciation | (492) | (637) | (778) | (912) | (1,006) | (1,140) |
| PBT | 7,959 | 7,672 | 12,259 | 12,799 | 13,686 | 16,205 |
| Tax | (2,777) | (2,984) | (3,870) | (4,249) | (4,544) | (5,380) |
| Net profit | 5,182 | 4,687 | 8,389 | 8,550 | 9,142 | 10,825 |
| Extraordinary items | 783 | 1,246 | 2,059 | — | — | — |
| RPAT | 5,965 | 5,933 | 10,449 | 8,550 | 9,142 | 10,825 |
| EPS (Rs) | 17.7 | 17.6 | 31.0 | 25.4 | 27.1 | 32.1 |
| Balance sheet | | | | | | |
| Equity share capital | 337 | 674 | 674 | 674 | 674 | 674 |
| Reserves & surplus | 15,572 | 20,017 | 28,492 | 35,041 | 42,044 | 50,336 |
| Shareholders funds | 15,909 | 20,691 | 29,166 | 35,715 | 42,718 | 51,010 |
| Loan funds | 15 | 11 | 6 | 2 | — | — |
| Total sources of funds | 15,924 | 20,701 | 29,172 | 35,717 | 42,718 | 51,010 |
| Net block | 4,637 | 5,572 | 6,295 | 7,383 | 8,377 | 9,487 |
| CWIP | 933 | 870 | 1,057 | 1,057 | 1,057 | 1,057 |
| Net fixed assets | 5,570 | 6,442 | 7,352 | 8,440 | 9,434 | 10,544 |
| Investments | 4,676 | 5,236 | 4,770 | 5,472 | 5,472 | 5,472 |
| Cash balances | 4,636 | 9,131 | 14,449 | 19,438 | 25,283 | 32,803 |
| Net current assets excl. cash | 768 | (1,018) | 1,482 | 1,248 | 1,410 | 1,072 |
| Total assets | 15,924 | 20,701 | 29,172 | 35,717 | 42,718 | 51,010 |
| Key ratios (%) | | | | | | |
| EBITDA margin | 9.5 | 9.3 | 12.1 | 12.7 | 11.5 | 11.4 |
| PAT margin | 6.7 | 5.6 | 9.9 | 8.8 | 8.0 | 8.0 |
| RoE | 38.7 | 25.6 | 33.7 | 26.4 | 23.3 | 23.1 |

Source: Company, Kotak Institutional Equities estimates

JULY 29, 2010

RESULT

Coverage view: **Attractive**

Price (Rs): **1,902**

Target price (Rs): **2,000**

BSE-30: **17,992**

Increasing visibility of FY2012E launches in US drives our PT upgrade. Though lower US sales pushed overall sales and PAT down in 1QFY11 vs our est., we believe growth outlook is intact in FY2011-12E due to (1) good growth in India as seen in 1QFY11, (2) increasing visibility of launches in US, (3) minimal threat of competition to Suprax in FY2012E, and (4) OCs launch from Sep 2012E. We lower our FY2011E PAT by 5% and increase our FY2012E PAT by 4%. Maintain ADD with PT revised to Rs2,000 (16X FY2012E earnings) from Rs1,920.

Company data and valuation summary

Lupin

Stock data

52-week range (Rs) (high,low) 1,985-900

Market Cap. (Rs bn) 168.5

Shareholding pattern (%)

Promoters 47.1

FIs 17.3

MFs 13.1

Price performance (%)

Absolute (1.2) 13.1 101.7

Rel. to BSE-30 (3.7) 10.0 70.1

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|------|-------|-------|
| EPS (Rs) | 77.0 | 99.1 | 127.6 |
| EPS growth (%) | 27.9 | 28.7 | 28.7 |
| P/E (X) | 24.7 | 19.2 | 14.9 |
| Sales (Rs bn) | 47.4 | 56.9 | 69.2 |
| Net profits (Rs bn) | 6.8 | 8.8 | 11.3 |
| EBITDA (Rs bn) | 8.5 | 11.8 | 15.0 |
| EV/EBITDA (X) | 21.1 | 15.3 | 11.7 |
| ROE (%) | 36.6 | 33.0 | 32.2 |
| Div. Yield (%) | 0.7 | 0.8 | 0.8 |

QUICK NUMBERS

- **PAT at Rs2 bn, 18% lower due to lower US sales and other income**
- **We increase FY2012E PAT by 4%**
- **Maintain ADD with PT revised to Rs2,000**

Sales at Rs13 bn was 8% lower than our estimate due to lower US revenues

Revenues from Indian finished dosages were higher than our estimate and grew 23% yoy vs our estimate of 20% sales growth. However, (1) US and European finished dosage (38% of sales) revenues at Rs5 bn was 16% lower than our estimate and (2) Japan (10% of sales) was 9% lower and grew only 2% yoy due to (a) one-time correction during the quarter on account of accounting adjustment and (b) price cuts.

PAT at Rs2 bn, 18% lower due to lower US sales and lower other income

PAT was lower than our estimate due to (1) lower sales by 8%, (2) lower adjusted EBITDA margin before R&D at 28%, 80 bps lower than our estimate, and (3) lower other income at Rs230 mn versus our estimate of Rs400 mn.

We increase FY2012E PAT by 4%; US pipeline intact and FY2012E to see number of launches

We lower FY2011E PAT estimate by 5% mainly on account of lower other income and increase FY2012E by 4% due to higher sales growth. We maintain our FY2011E sales growth estimate at 20% and increase sales growth estimate in FY2012E to 22% versus 18% earlier on account of (1) increasing number of launches in US and (2) minimal threat of competition to Suprax in branded segment for next 12-18 months.

Maintain ADD with PT revised to Rs2,000 (16X FY2012E earnings) from Rs1,920

We estimate PAT growth of 29% in FY2011-12E on account of (1) sales growth of 20-22% in FY2011-12E, and (2) margin expansion by 100 bps in FY2012E. Due to PAT increase of 4% in FY2012E, we increase our target price to Rs2,000 (was Rs1,920).

Priti Arora
priti.arora@kotak.com
Mumbai: +91-22-6634-1551

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

1QFY11 revenues at Rs13 bn, 8% lower than our estimate due to lower US revenues

- ▶ US and European finished dosage (38% of sales) revenues at Rs5 bn was 16% lower than our estimate.
 - LPC now has 26 products in the US market, of which 13 are market leaders and 24 rank in the top three by market share.
 - US branded business grew 52% yoy in dollar terms while generic business grew 57%. The yoy growth in branded business was due to addition of Antara revenues from 3QFY10. Antara has been promoted from September 2009 and LPC has ramped up its US sales force to 170 from 70 earlier with 100 dedicated to primary care.
 - Growth in US generics at 52% in dollar terms was due to launch of Lotrel in February 2010. LPC continues to enjoy a high market share in generic Lotrel at 275 in unit terms.
 - LPC made 3 ANDA filings in 1QFY11 taking cumulative filings pending approval at 85.
- ▶ Japanese revenues at Rs1.3 bn, was 9% lower and grew only 2% yoy. This was due to (1) one-time correction during the quarter on account of accounting adjustment and (2) price cuts. One product was launched in Japan in 1QFY11 and LPC plans to launch four more products in FY2011E.
- ▶ India finished dosage sales (32% of sales) at Rs4.2 bn grew 23% yoy versus our sales growth estimate of 20% yoy.

PAT at Rs2 bn, 18% lower due to lower US sales and other income

PAT was lower than our estimate due to (1) lower sales by 8%, (2) lower adjusted EBITDA margin before R&D at 28%, 80 bps lower than our estimate and (3) lower other income at Rs230 mn versus our estimate of Rs400 mn.

Interim results- Lupin, March fiscal year-ends (Rs mn)

| | 1QFY11 | 1QFY11E | 1QFY10 | 4QFY10 | % change | | |
|-------------------------|---------------|---------------|---------------|---------------|-------------|-----------|-------------|
| | | | | | 1QFY11E | 1QFY10 | 4QFY10 |
| Net sales | 13,121 | 14,296 | 10,856 | 12,848 | (8) | 21 | 2 |
| Net material cost | 5,036 | 6,005 | 4,676 | 4,882 | (16) | 8 | 3 |
| Personnel cost | 1,781 | 1,600 | 1,315 | 1,624 | 11 | 35 | 10 |
| R&D | 1,038 | 1,072 | 685 | 1,124 | (3) | 52 | (8) |
| Other expenses | 2,645 | 2,600 | 2,238 | 2,728 | 2 | 18 | (3) |
| Total expenditure | 10,499 | 11,277 | 8,914 | 10,358 | (7) | 18 | 1 |
| EBITDA | 2,622 | 3,019 | 1,942 | 2,491 | (13) | 35 | 5 |
| Other income | 230 | 400 | 211 | 539 | (42) | 9 | (57) |
| Interest expense | 82 | 90 | 107 | 78 | (9) | (24) | 5 |
| Depreciation | 401 | 400 | 231 | 408 | — | 74 | (2) |
| PBT | 2,370 | 2,929 | 1,815 | 2,543 | (19) | 31 | (7) |
| Tax | 350 | 498 | 364 | 293 | (30) | (4) | 19 |
| Minority interest | — | 35 | 33 | 24 | NM | NM | NM |
| PAT | 2,020 | 2,396 | 1,419 | 2,227 | (16) | 42 | (9) |
| Share of associate | 57 | 15 | 17 | 21 | 283 | 230 | 173 |
| Reported PAT | 1,963 | 2,381 | 1,401 | 2,206 | (18) | 40 | (11) |
| API | 1,876 | 1,895 | 1,752 | 1,700 | (1) | 7 | 10 |
| Finished dosages | 9,547 | 10,741 | 7,564 | 9,541 | (11) | 26 | 0 |
| India | 4,242 | 4,133 | 3,444 | 2,651 | 3 | 23 | 60 |
| Developing markets | 339 | 730 | 569 | 1,016 | (54) | (40) | (67) |
| Advanced markets | 4,966 | 5,879 | 3,551 | 5,874 | (16) | 40 | (15) |
| Others | 1,698 | 1,730 | 1,608 | 1,607 | (2) | 6 | 6 |
| Kyowa (Japan) | 1,299 | 1,430 | 1,307 | 1,262 | (9) | (1) | 3 |
| South Africa | 399 | 300 | 301 | 345 | 33 | 33 | 16 |
| Total | 13,121 | 14,366 | 10,924 | 12,848 | (9) | 20 | 2 |

Source: Kotak Institutional Equities estimates, Company

Key takeaways from call—US pipeline remains intact

- ▶ US product pipeline in F2011E intact. LPC expects to launch 3-4 products in US upon approval in FY2011E.
- ▶ Allernaze launch in 2HFY11E. LPC expects to launch Allernaze in August 2010 in the branded segment and expects to ramp up sales of Antara which grew only 9% yoy in 1QFY11 in 2HFY11E.
- ▶ OCs to be launched in September 2011E. LPC has made 22 filings in the OC (oral contraceptives) category with US FDA. It expects to file some additional OC products in FY2011E. LPC expects the first set of OC approvals in 2011E and expects to launch couple of OC products by September 2011E. We retain our estimate of US\$50 m revenues from oral contraceptive segment in FY2012E.
- ▶ Clear visibility of launches in US in FY2012E: LPC expects number of approvals in US in FY2012E which includes Tricor in 2QFY12E, Effexor XR in June 2011E, Fortamet ER, Combivir in 3QFY12E.
- ▶ Despite the slow start in 1QFY11 where Japanese revenues grew at 2% yoy, FY2011E sales growth is expected at 12-15%. Plans are also underway to (1) manufacture initially 5 APIs for the Japanese market in its Indian facilities, and (2) backend production in order to free up capacity in its Kyowa plant. LPC expects these measures to increase margins in FY2012E.

We increase FY2012E PAT by 4%

We are using Rs/US\$ forecast of Rs46 for FY2011-12E

- ▶ We maintain our FY2011E sales growth estimate at 20% and increase sales growth estimate in FY2012E to 22% versus 18% earlier on account of (1) increasing number of launches in US and (2) minimal threat of competition to Suprax in branded segment for next 12-18 months. We expect LPC's India finished dosage business to grow at 21% in FY2011E and 17% in FY2012E.
- ▶ We forecast EBITDA margins adjusted for R&D at 28% for FY2011E and 29% in FY2012E. We think margin expansion in FY2012E is likely due to launch of products in high-margin, limited competition oral contraceptive segment.

Profit and loss statement, March fiscal year-ends, 2007-2012E (Rs mn)

| | 2007 | 2008 | 2009 | 2010 | 2011E | 2012E |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Net sales | 20,137 | 27,064 | 37,759 | 47,405 | 56,901 | 69,205 |
| Operating expenses | | | | | | |
| Materials | (10,250) | (12,897) | (17,770) | (19,694) | (24,470) | (29,462) |
| Selling and administration | (3,406) | (5,075) | (6,727) | (9,733) | (9,612) | (11,765) |
| Employee cost | (2,200) | (3,076) | (4,549) | (5,872) | (6,731) | (7,740) |
| R&D | (1,359) | (1,657) | (2,228) | (3,570) | (4,328) | (5,190) |
| Total expenditure | (17,215) | (22,705) | (31,274) | (38,869) | (45,141) | (54,157) |
| EBITDA | 2,922 | 4,358 | 6,485 | 8,536 | 11,759 | 15,047 |
| Depreciation and amortisation | (466) | (647) | (880) | (1,239) | (1,601) | (1,800) |
| EBIT | 2,456 | 3,711 | 5,605 | 7,297 | 10,159 | 13,247 |
| Net finance cost | (372) | (374) | (499) | (385) | (352) | (300) |
| Other income | 1,991 | 2,065 | 954 | 1,445 | 980 | 1,000 |
| Pretax profits before extra-ordinaries | 4,074 | 5,402 | 6,060 | 8,357 | 10,787 | 13,947 |
| Current tax | (860) | (1,137) | (877) | (1,360) | (1,610) | (2,311) |
| Deferred tax | (129) | (181) | (106) | — | (200) | (200) |
| Reported net profit | 3,086 | 4,084 | 5,077 | 6,997 | 8,977 | 11,437 |
| Minority interests/share of loss in ass | 1 | 1 | 62 | 180 | 207 | 151 |
| Reported net profit after minority interests | 3,086 | 4,083 | 5,015 | 6,816 | 8,770 | 11,286 |

Source: Kotak Institutional Equities estimates, Company

Change in estimates

| | Current estimates | | Previous estimates | | % change | |
|----------------------------|-------------------|---------------|--------------------|---------------|------------|----------|
| | FY2011E | FY2012E | FY2011E | FY2012E | FY2011E | FY2012E |
| Net sales | 56,901 | 69,205 | 56,913 | 67,384 | (0) | 3 |
| Consumption of RM | (23,037) | (26,348) | (23,332) | (25,749) | (1) | 2 |
| Personnel cost | (6,731) | (7,740) | (6,550) | (7,533) | 3 | 3 |
| R&D | (4,328) | (5,190) | (4,268) | (5,054) | 1 | 3 |
| Other expenses | (11,045) | (14,879) | (11,000) | (14,488) | — | 3 |
| Total Expenditure | (45,141) | (54,157) | (45,150) | (52,823) | (0) | 3 |
| EBITDA | 11,759 | 15,047 | 11,763 | 14,562 | (0) | 3 |
| Other income | 980 | 1,000 | 1,600 | 1,000 | (39) | — |
| Interest expense | (352) | (300) | (360) | (300) | (2) | — |
| Depreciation | (1,601) | (1,800) | (1,600) | (1,800) | — | — |
| PBT | 10,787 | 13,947 | 11,403 | 13,462 | (5) | 4 |
| Tax | (1,810) | (2,511) | (1,937) | (2,423) | (7) | 4 |
| PAT | 8,977 | 11,437 | 9,465 | 11,039 | (5) | 4 |
| PAT post exceptionals | 8,977 | 11,437 | 9,465 | 11,039 | (5) | 4 |
| Minority Interest | (105) | (121) | (140) | (161) | (25) | (25) |
| Net profit post MI | 8,872 | 11,316 | 9,325 | 10,878 | (5) | 4 |
| Share of loss in associate | (102) | (30) | (60) | (30) | 71 | — |
| Reported PAT | 8,770 | 11,286 | 9,265 | 10,848 | (5) | 4 |

Source: Kotak Institutional Equities, Kotak Institutional Equities estimates, Company

Balance sheet, cash model, March fiscal year-ends, 2007-2012E (Rs mn)

| | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E |
|--|----------------|----------------|---------------|----------------|---------------|---------------|
| Balance sheet | | | | | | |
| Total equity | 8,733 | 12,797 | 14,249 | 22,961 | 30,230 | 39,912 |
| Total debt | 8,648 | 12,029 | 12,232 | 11,908 | 11,642 | 8,199 |
| Current liabilities | 4,222 | 7,470 | 13,331 | 10,181 | 11,882 | 13,485 |
| Minority Interests | — | 95 | 143 | 254 | 359 | 480 |
| Deferred tax liabilities | 1,026 | 1,107 | 1,164 | 1,164 | 1,364 | 1,564 |
| Total equity and liabilities | 22,629 | 33,497 | 41,119 | 46,468 | 55,477 | 63,640 |
| Cash and cash equivalents | 3,845 | 2,742 | 778 | 200 | 300 | 400 |
| Current assets | 10,785 | 17,699 | 22,700 | 23,542 | 29,052 | 36,415 |
| Net fixed assets | 7,146 | 10,161 | 12,012 | 15,273 | 18,672 | 19,372 |
| Intangible assets | — | 1,872 | 3,174 | 4,998 | 4,998 | 4,998 |
| Capital -WIP | 826 | 964 | 2,240 | 2,240 | 2,240 | 2,240 |
| Investments | 28 | 58 | 216 | 216 | 216 | 216 |
| Total assets | 22,629 | 33,497 | 41,119 | 46,468 | 55,477 | 63,640 |
| Free cash flow | | | | | | |
| Operating cash flow, excl. working capital | 2,327 | 3,453 | 5,576 | 7,348 | 10,055 | 12,663 |
| Working capital | (1,819) | (4,157) | 610 | (4,181) | (3,909) | (5,863) |
| Capital expenditure | (1,540) | (5,469) | (4,617) | (4,500) | (5,000) | (2,500) |
| Investments | — | (59) | (157) | — | — | — |
| Free cash flow | (1,032) | (6,232) | 1,411 | (1,333) | 1,145 | 4,299 |

Source: Kotak Institutional Equities estimates, Company

JULY 29, 2010

RESULT, CHANGE IN RECO.

Coverage view: **Neutral**

Price (Rs): **870**

Target price (Rs): **985**

BSE-30: **17,992**

One step away. Ultratech (UTCEM) is one step away from merging with Samruddhi to create India's largest cement company with a combined capacity of 52 mn tpa. In our view, the merger with Samruddhi is earnings accretive, and UTCEM will benefit from the pan-India presence of the combined entity. We believe that the historical trading discount for UTCEM over peers will likely minimize and recommend an ADD rating with a revised target price of Rs985/share.

Company data and valuation summary

UltraTech Cement

| Stock data | | | | Forecasts/Valuations | | | | |
|-------------------------------|-----------|--------|-------|----------------------|-------|--------|------|--|
| | | | | 2010 | 2011E | 2012E | | |
| 52-week range (Rs) (high,low) | 1,174-669 | | | EPS (Rs) | 88.2 | 66.9 | 75.1 | |
| Market Cap. (Rs bn) | 108.3 | | | EPS growth (%) | 12.0 | (24.2) | 12.4 | |
| Shareholding pattern (%) | | | | P/E (X) | 9.9 | 13.0 | 11.6 | |
| Promoters | 54.8 | | | Sales (Rs bn) | 70.5 | 72.4 | 82.1 | |
| FIs | 11.1 | | | Net profits (Rs bn) | 11.0 | 8.3 | 9.4 | |
| MFs | 2.4 | | | EBITDA (Rs bn) | 20.7 | 17.0 | 19.5 | |
| Price performance (%) | | | | EV/EBITDA (X) | 5.2 | 6.3 | 5.2 | |
| Absolute | 1M | 3M | 12M | ROE (%) | 25.9 | 16.7 | 16.3 | |
| Rel. to BSE-30 | (1.1) | (10.6) | 9.1 | Div. Yield (%) | 0.7 | 0.9 | 0.9 | |
| | (2.7) | (12.7) | (6.6) | | | | | |

Results meet estimates, realizations improve sequentially

UTCEM reported revenues of Rs17.9 bn (-8% yoy, -6% qoq), operating profits of Rs4.1 bn (-43% yoy, 1% qoq) and net income of Rs2.4 bn (-42% yoy, 6% qoq) against our estimate of Rs17.8 bn, Rs4.4 bn and Rs2.3 bn, respectively. EBITDA at Rs4.1 bn was below our estimate on account of higher power and fuel cost. Sequential improvement in realizations of Rs3,496/ton (Rs3,379/ton in 4QFY10) helped combat cost pressures and compensated for lower volumes of 5.1 mn tons in 1QFY11. The increase in power and fuel cost was primarily due to an increase in the price of imported coal which increased from US\$76/ton to US\$110/ton yoy resulting in a 13% yoy increase in power and fuel cost.

Merger with Samruddhi earnings accretive, and de-risks South concentration

The merger with Samruddhi is earnings accretive for UTCEM and will increase the EPS by 4% in FY2011E and 31% in FY2012E. The pan-India presence will also help UTCEM, which has a dominant presence in South, combat the pressure on its near-term earnings due the sharp deterioration in cement prices in that region (especially Andhra Pradesh). Grasim and UTCEM already benefit from (1) common sales and marketing team, (2) unified cement brand under 'Ultratech', and (3) divergent regional exposure with each having carved out its key markets (see Exhibit 4).

We note that on a post merger basis, UTCEM's EPS will increase from Rs67/share to Rs69/share in FY2011E and from Rs75/share to Rs99/share in FY2012E (see Exhibit 2) and the consolidated entity is trading at 4.8X EV/EBITDA and 8.9X P/E on FY2012E earnings.

Valuation discount to peers likely to narrow, upgrade to ADD

We upgrade UTCEM to ADD with a revised target price of Rs985/share. UTCEM has traditionally traded at a discount to its peers (Historical Average: 9X EV/EBITDA for ACC) though the creation of a large pure-play cement entity will likely reduce this discount, in our view. Our target price implies an EV/EBITDA of 6.0X on FY2012E earnings and EV/ton of US\$104/ton on FY2012E production. We have revised our EPS estimate to Rs75/share (previously Rs77/share) in FY2012E.

Murtuza Arsiwalla
murtuza.arsiwalla@kotak.com
Mumbai: +91-22-6634-1125

Shubham Satyarth
shubham.satyarth@kotak.com
Mumbai: +91-22-6634-1320

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Exhibit 1: Blended realizations improve qoq, higher power and fuel cost dents profitability
Quarterly results for UltraTech Cement, March fiscal year-ends (Rs mn)

| | 1QFY11 | 1QFY11E | 1QFY10 | 4QFY10 | Change (%) | | | 2011E | 2010 | (% chg) |
|-------------------------------|---------------|---------------|---------------|---------------|------------|-------------|------------|---------------|---------------|---------------|
| | | | | | 1QFY11E | 1QFY10 | 4QFY10 | | | |
| Net sales | 17,898 | 17,799 | 19,528 | 19,094 | 1 | (8) | (6) | 72,443 | 70,497 | 2.8 |
| Raw materials | (2,219) | (2,601) | (2,321) | (3,322) | | | | (9,467) | (9,629) | |
| Employee costs | (695) | (680) | (589) | (660) | | | | (2,933) | (2,506) | |
| Power costs | (4,178) | (3,570) | (3,833) | (3,651) | | | | (17,361) | (14,309) | |
| Freight costs | (3,586) | (3,264) | (3,049) | (3,485) | | | | (15,040) | (12,288) | |
| Purchase of finished goods | (330) | (128) | (114) | (292) | | | | (450) | (637) | |
| Other costs | (2,834) | (3,203) | (2,454) | (3,657) | | | | (11,821) | (11,697) | |
| EBITDA | 4,057 | 4,354 | 7,168 | 4,026 | (7) | (43) | 1 | 15,371 | 19,430 | (20.9) |
| EBITDA (%) | 22.7 | 24.5 | 36.7 | 21.1 | | | | 21.2 | 27.6 | |
| Other income | 483 | 325 | 342 | 258 | | | | 1,585 | 1,227 | |
| Interest | (279) | (319) | (330) | (285) | | | | (1,039) | (1,175) | |
| Depreciation | (1,016) | (1,040) | (936) | (993) | | | | (4,129) | (3,881) | |
| PBT | 3,246 | 3,319 | 6,244 | 3,007 | (2) | (48) | 8 | 11,788 | 15,601 | (24.4) |
| Tax | (819) | (996) | (2,067) | (721) | | | | (3,092) | (3,871) | |
| Deferred tax | — | — | — | — | | | | (370) | (1,078) | |
| PAT | 2,427 | 2,323 | 4,178 | 2,285 | 4 | (42) | 6 | 8,325 | 10,652 | (21.8) |
| Extraordinaries | — | — | — | — | | | | — | — | |
| Reported PAT | 2,427 | 2,323 | 4,178 | 2,285 | | | | 8,325 | 10,652 | |
| Sales (mn tons) | 5.1 | 5.1 | 5.3 | 5.7 | 0 | (4) | (9) | 21.8 | 20.2 | 7.7 |
| Realization (Rs/ton) | 3,496 | 3,490 | 3,678 | 3,379 | 0 | (5) | 3 | 3,329 | 3,488 | (4.6) |
| Cost (Rs/ton) | 2,703 | 2,636 | 2,328 | 2,667 | | | | 2,623 | 2,527 | |
| Raw materials | 433 | 510 | 437 | 588 | | | | 435 | 476 | |
| Employee costs | 136 | 133 | 111 | 117 | | | | 135 | 124 | |
| Power & fuel costs | 816 | 700 | 722 | 646 | | | | 798 | 708 | |
| Freight costs | 700 | 640 | 574 | 617 | | | | 691 | 608 | |
| Purchase of finished goods | 64 | 25 | 22 | 52 | | | | 21 | 32 | |
| Other costs | 554 | 628 | 462 | 647 | | | | 543 | 579 | |
| Profitability (Rs/ton) | 792 | 854 | 1,350 | 713 | (7) | (41) | 11 | 706 | 961 | (26.5) |
| Tax rate (%) | 25.2 | 30.0 | 33.1 | 24.0 | | | | 29.4 | 31.7 | |

Source: Company, Kotak Institutional Equities estimates

Detailed analysis of quarterly results

- ▶ **Realization.** Blended realizations increased from Rs3,379/ton in 4QFY10 to Rs3,496 mn tons as prices, due to the price increases taken in South India (especially Tamil Nadu) in the month of April 2010. We continue to remain cautious on the price trend in South and West, and factor ~Rs15/bag decline through the remainder of the year.
- ▶ **Power and fuel cost.** UTCEM's power and fuel cost increased from Rs722/ton in 1QFY10 to Rs816/ton in 1QFY11, primarily driven by a steep increase in the price of imported coal, which increased to US\$110/ton yoy from US\$76/ton. Part of the cost can be ascribed to reduced availability of domestic coal supply through linkages (at notified prices) and increasing dependence on open market purchases.
- ▶ **Freight cost.** Freight cost also increased Rs617/ton in 4QFY10 to Rs700/ton in 1FY11 as the company continues to reach out to distant markets in the face of increasing disparity in prices across regions.

Exhibit 2: UTCCEM appears even cheaper on a post merger basis
Key financials and valuation of UTCCEM

| | Ultratech | | Samruddhi | | Ultratech + Samruddhi | |
|--------------------------|---------------|---------------|---------------|----------------|-----------------------|----------------|
| | FY2011E | FY2012E | FY2011E | FY2012E | FY2011E | FY2012E |
| Net sales | 72,443 | 82,108 | 65,714 | 102,509 | 138,156 | 184,617 |
| EBITDA | 16,955 | 19,527 | 18,009 | 29,616 | 34,965 | 49,143 |
| PAT | 8,325 | 9,354 | 10,656 | 17,660 | 18,981 | 27,015 |
| Capacity (mn tpa) | 23 | 25 | 24 | 24 | 48 | 50 |
| Production (mn tons) | 22 | 24 | 23 | 26 | 45 | 50 |
| Shares (mn) | 124 | 124 | 262 | 262 | 274 | 274 |
| EPS (Rs/share) | 67 | 75 | 41 | 67 | 69 | 99 |
| Net debt | (1,976) | (5,967) | 15,540 | 711 | 13,564 | (5,255) |
| Market Cap. | 108,680 | 108,680 | 125,878 | 125,878 | 239,231 | 239,231 |
| EV | 106,704 | 102,713 | 141,417 | 126,589 | 252,794 | 233,975 |
| EV/EBITDA | 6.3 | 5.3 | 7.9 | 4.3 | 7.2 | 4.8 |
| US\$/ton | 106 | 92 | 134 | 105 | 122 | 101 |
| P/E | 13.1 | 11.6 | 11.8 | 7.1 | 12.6 | 8.9 |

Note:

(a) FY2011E numbers are adjusted for effective merger date of 1st July 2010

Source: Company, Kotak Institutional Equities estimates

Exhibit 3: Cement realizations have remained stable

Sales mix, volumes and realizations for Ultratech

| | 1QFY11 | 1QFY10 | 4QFY10 | Growth (%) | |
|---------------------------|-------------|-------------|-------------|-------------|------------|
| | | | | yoy | qoq |
| Revenues (Rs bn) | | | | | |
| Net sales | 17.9 | 19.5 | 19.1 | (8) | (6) |
| RMC sales | 1.6 | 1.2 | 1.4 | 34 | 8 |
| Non-RMC sales | 16.3 | 18.4 | 17.7 | (11) | (7) |
| Volumes (mn tons) | | | | | |
| Domestic sales | 4.6 | 4.7 | 4.9 | (2) | (8) |
| Export sales | 0.1 | 0.7 | 0.2 | (82) | (20) |
| Cement sales | 4.7 | 5.3 | 5.1 | (12) | (8) |
| Realizations | | | | | |
| Cement-domestic (Rs/ton) | 3,400 | 3,700 | 3,330 | (8) | 2 |
| Cement-export (US\$/ton) | | 50 | 50 | | |
| Clinker-export (US\$/ton) | 33 | 36 | 30 | (8) | 10 |

Source: Company, Kotak Institutional Equities

South and West concentration weighs on realizations during the quarter

UTCCEM sells ~75% of its output in South and West, which have seen average realizations decline by 13% yoy and 5% qoq, respectively. The South saw realizations drop by ~Rs20/bag during the quarter on the back of continued influx of capacities, whereas new entrants like Jaiprakash distorted the pricing discipline in West as they launched in the states of Gujarat and Maharashtra. We are encouraged by UTCCEM's 3% qoq increase in realizations despite the weak demand environment in its key market.

Exhibit 4: Merger will diversify the geographic exposure of UTCEM
Region wise sale mix of UTCEM (%)

| | Ultratech | | Samruddhi | | Ultratech+Samruddhi | |
|--------------|--------------|--------------|--------------|--------------|---------------------|--------------|
| | FY2011E | FY2012E | FY2011E | FY2012E | FY2011E | FY2012E |
| North | 0.0 | 0.0 | 37.6 | 39.2 | 19.5 | 20.6 |
| Central | 6.9 | 6.9 | 24.6 | 25.7 | 16.1 | 16.8 |
| East | 15.1 | 15.1 | 7.4 | 7.1 | 11.1 | 10.9 |
| West | 42.7 | 42.5 | 15.3 | 14.0 | 28.5 | 27.5 |
| South | 32.5 | 33.0 | 15.1 | 13.9 | 23.5 | 23.0 |
| Exports | 2.8 | 2.5 | 0.0 | 0.0 | 1.3 | 1.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Company, Kotak Institutional Equities estimates

Capex and capacity addition plans

UTCCEM plans to incur a capex of Rs26 bn over the next three years. We highlight key capex guidance provided by the management

- ▶ Rs26 bn has been earmarked for (1) augmenting the grinding capacity in Gujarat, (2) installation of waste heat recovery systems and (3) setting up packaging terminals
- ▶ Additional Rs56 bn has been approved for setting up clinker capacities in Chhattisgarh and Karnataka and additional grinding capacities. Management has indicated that the expansion plan will add 9.2 mn tpa of capacity
- ▶ Along with Samruddhi, the total capex outlay for next three years will be ~Rs100 bn as indicated by the management.

Exhibit 5: Profit model, balance sheet and cash model of Ultratech, March fiscal year-ends, 2008-13E (Rs mn)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|--|---------------|----------------|---------------|---------------|----------------|----------------|
| Profit model (Rs mn) | | | | | | |
| Net sales | 55,092 | 63,831 | 70,497 | 72,443 | 82,108 | 85,046 |
| EBITDA | 17,198 | 17,075 | 19,430 | 15,371 | 17,943 | 18,142 |
| Other income | 999 | 1,036 | 1,227 | 1,585 | 1,584 | 1,720 |
| Interest | (757) | (1,255) | (1,175) | (1,039) | (984) | (882) |
| Depreciation | (2,372) | (3,230) | (3,881) | (4,129) | (4,591) | (4,970) |
| Pretax profits | 15,067 | 13,625 | 15,601 | 11,788 | 13,953 | 14,010 |
| Tax | (5,161) | (2,039) | (3,871) | (3,092) | (4,056) | (4,070) |
| Deferred taxation | 167 | (1,806) | (1,078) | (370) | (542) | (548) |
| Net profits | 10,073 | 9,781 | 10,652 | 8,325 | 9,354 | 9,393 |
| Extraordinary items | — | — | — | — | — | — |
| Earnings per share (Rs) | 80.9 | 78.6 | 85.6 | 66.9 | 75.1 | 75.4 |
| Balance sheet (Rs mn) | | | | | | |
| Total equity | 26,970 | 36,021 | 46,087 | 53,392 | 61,727 | 70,100 |
| Deferred taxation liability | 5,424 | 7,229 | 8,307 | 8,677 | 9,220 | 9,768 |
| Total borrowings | 17,405 | 21,416 | 16,045 | 15,545 | 15,045 | 15,529 |
| Current liabilities | 12,786 | 12,427 | 12,991 | 13,466 | 15,204 | 15,873 |
| Total liabilities and equity | 62,584 | 77,094 | 83,430 | 91,081 | 101,196 | 111,269 |
| Cash | 1,007 | 1,045 | 837 | 8,521 | 12,012 | 18,264 |
| Current assets | 12,032 | 12,571 | 13,887 | 16,678 | 18,893 | 19,566 |
| Total fixed assets | 47,836 | 53,130 | 52,011 | 56,882 | 61,291 | 65,321 |
| Investments | 1,709 | 10,348 | 16,696 | 9,000 | 9,000 | 9,000 |
| Total assets | 62,584 | 77,094 | 83,430 | 91,081 | 101,196 | 112,151 |
| Free cash flow (Rs mn) | | | | | | |
| Operating cash flow, excl. working capital | 11,008 | 13,732 | 14,433 | 11,240 | 12,903 | 14,072 |
| Working capital | 3,615 | 193 | (752) | (2,316) | (477) | (4) |
| Capital expenditure | (17,741) | (8,226) | (2,592) | (9,000) | (9,000) | (9,000) |
| Investments | 3,087 | (8,639) | (6,348) | 7,696 | 0 | 0 |
| Free cash flow | (31) | (2,940) | 4,741 | 7,619 | 3,426 | 5,068 |

Source: Company, Kotak Institutional Equities estimates

JULY 29, 2010

RESULT

Coverage view: **Cautious**

Price (Rs): **263**

Target price (Rs): **318**

BSE-30: **17,992**

Good quarter; re-instate ADD rating. HDIL's 1QFY11 reflected a strong pricing environment for TDRs and higher-margin FSI sale while TDR sale volumes were lower than expected due to captive use. Revenues are up 53% yoy while EBITDA margins expanded 200 bps yoy and 700 bps qoq led by the improvement in TDR prices to above ₹3,000/sq. ft. We believe Mumbai market provides HDIL enough growth opportunities to accrue NAV. Re-instate our ADD rating with a revised target price of ₹318/share.

Company data and valuation summary

Housing Development & Infrastructure

| Stock data | | Forecasts/Valuations | | | |
|-------------------------------|------------------|----------------------|--------|-------|------|
| | | 2010 | 2011E | 2012E | |
| 52-week range (Rs) (high,low) | 411-202 | EPS (Rs) | 12.4 | 14.2 | 16.7 |
| Market Cap. (Rs bn) | 97.7 | EPS growth (%) | (41.2) | 14.2 | 17.9 |
| Shareholding pattern (%) | | P/E (X) | 21.2 | 18.6 | 15.7 |
| Promoters | 50.2 | Sales (Rs bn) | 15.0 | 18.5 | 29.3 |
| FIs | 27.9 | Net profits (Rs bn) | 5.7 | 7.0 | 8.3 |
| MFs | 1.3 | EBITDA (Rs bn) | 12.7 | 11.2 | 16.8 |
| Price performance (%) | | EV/EBITDA (X) | 10.3 | 11.7 | 7.7 |
| Absolute | 1M 3M 12M | ROE (%) | 10.0 | 9.3 | 9.9 |
| Rel. to BSE-30 | 6.7 (1.1) (1.9) | Div. Yield (%) | 1.1 | 1.9 | 1.9 |
| | 4.0 (3.8) (17.3) | | | | |

1QFY11 revenues driven by higher TDR prices and FSI sales

HDIL reported 1QFY11 revenues of ₹4.5 bn (+53% yoy, +4% qoq) versus our estimate of ₹5.2 bn. EBITDA margins at 59% (+2,000 bps yoy and +700 bps qoq) were substantially better than our expectation of 45%. PAT was at ₹2.3 bn (+118% yoy, +28% qoq) versus our estimate of ₹1.8 bn. Revenues were lower than estimated led by lower TDR sales of 1.1 mn sq. ft in 1QFY11 (versus 1.5 mn in 4QFY10 and 1.8 mn in 1QFY10) which was partially made up by (1) higher TDR prices at around ₹3,000/sq. ft versus our estimate of ₹2,200/sq. ft and (2) FSI sales in Virar. Both these factors also led to the higher-than-expected EBITDA margin with FSI sales recording an EBITDA margin of 65%.

Real estate business continues to progress well

HDIL has 19 ongoing projects for 62.6 mn sq. ft comprising (1) redevelopment (47 mn sq. ft, 75% of total), (2) residential (9.2 mn sq. ft, 15%), (3) commercial (5.4 mn sq. ft, 9%) and (4) retail (1 mn sq. ft, 1%). Key projects continue to do well with Premier and Galaxy (Kurla), Harmony (Goregaon) and Metropolis (Andheri) 90%+ sold out. Relocation under Phase 1 of the airport rehabilitation project is less than three months away and continues to generate 1.7-1.8 mn TDRs annually.

ADD with target price of ₹318

We revise our NAV to ₹353 (earlier ₹392/share) to incorporate (1) further issuance of 26 mn warrants to promoter group which is NAV dilutive as our target NAV is higher than current market price at which they are issued and (2) lower TDR volumes as they are partly being used for internal development projects. We also incorporate into our NAV (1) conversion of 2 mn sq. ft in Kurla (W) to rental property and (2) higher FSI available in Vasai-Virar due to MMRDA rental housing scheme. We retain ADD rating with a revised target price of ₹318 (earlier ₹350) which is based on a 10% discount to our revised NAV. We assign a discount of 10% on account of riskier nature of slum rehabilitation business. Key upside risks to NAV include better TDR prices and lower construction costs. Downside risks include lower residential demand due to higher interest rates/selling prices and leasing risk.

QUICK NUMBERS

- PAT up 118% yoy to ₹2.3 bn
- 19 ongoing projects of 62.6 mn sq. ft

Ajay Mathrani
ajay.mathrani@kotak.com
Mumbai: +91-22-6634-1376

Dhruva Acharya
dhruva.acharya@kotak.com
Mumbai: +91-22-6634-1417

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

1QFY11 – better TDR prices and FSI sales overcome lower TDR sales

Interim results, HDIL, March fiscal year-ends (₹ mn)

| (in Rs mn) | 1QFY11 | 1QFY11E | 4QFY10 | 1QFY10 | % chg | | |
|--------------------------------|----------------|----------------|----------------|----------------|---------------|---------------|--------------|
| | | | | | 1QFY11E | qoq | yoy |
| Net sales | 4,509 | 5,246 | 4,341 | 2,954 | (14.0) | 3.9 | 52.7 |
| Operating costs | (1,835) | (2,885) | (2,070) | (1,793) | (36.4) | (11.3) | 2.4 |
| Cost of land/construction cost | (7,474) | | (5,573) | (4,182) | | 34.1 | 78.7 |
| Staff Cost | (104) | | (78) | (53) | | 32.5 | 94.7 |
| Other Expenditure | (1,232) | | (1,178) | (1,193) | | 4.6 | 3.3 |
| Increase/(Decrease) in Stock | 6,974 | | 4,759 | 3,636 | | 46.5 | 91.8 |
| EBITDA | 2,674 | 2,361 | 2,271 | 1,161 | 13.3 | 17.7 | 130.3 |
| Other income | 342 | 414 | 304 | 233 | (17.3) | 12.6 | 47.1 |
| Interest costs | (215) | (300) | (245) | (169) | (28.5) | (12.5) | 27.1 |
| Depreciation | (19) | (16) | (21) | (9) | 20.1 | (10.6) | 125.9 |
| PBT | 2,782 | 2,458 | 2,309 | 1,216 | 13.2 | 20.5 | 128.7 |
| Taxes | (439) | (615) | (474) | (142) | (28.6) | (7.4) | 209.8 |
| PAT | 2,343 | 1,844 | 1,835 | 1,075 | 27.1 | 27.7 | 118.0 |
| Key ratios | | | | | | | |
| EBITDA margin (%) | 59.3 | 45.0 | 52.3 | 39.3 | | | |
| PAT margin (%) | 52.0 | 35.1 | 42.3 | 36.4 | | | |
| Effective tax rate (%) | 15.8 | 25.0 | 20.5 | 11.6 | | | |

Source: Company, Kotak Institutional Equities estimates

Other key issues—warrant issuance, progress of airport project, maintenance of healthy debt level

- ▶ HDIL intends to issue a further 26 mn equity warrants to promoters exercisable over the next 18 months. If and when these are exercised, promoter stake with increase to around 47%.
- ▶ Progress of airport project. Families will start moving to the project in less than three months and Phase I could be completed in CY2010E. HDIL has launched small rehabilitation projects of around 2,000 families in Kurla (>75% complete) and 2,500 in Bhandup (>25% complete).
- ▶ Desired D/E ratio. Debt remained stable qoq with current D/E at 0.5X which the management is comfortable with and does not intend to repay any loans earlier than due to reduce this further though they will be cautious in taking more debt. We need to watch absolute debt level and D/E closely and would like HDIL reinvest operating cash flows to acquire land rather than raising debt levels.
- ▶ Debtors. Debtors have increased by ₹1.6 bn during 1QFY11 to ₹3.6 bn. Around 25% of 1QFY11 revenues have resulted in debtors. Management mentioned that this is due to sale of FSI close towards quarter end and that the debtor level is down already from ₹3.6 bn.

Consolidated summary statement of assets and liabilities
Quarterly Balance Sheet, HDIL, March fiscal year-ends (₹ mn)

| | 1QFY09 | 2QFY09 | 3QFY09 | 4QFY09 | 1QFY10 | 2QFY10 | 3QFY10 | 4QFY10 | 1QFY11 |
|---|---------------|---------------|---------------|---------------|---------------|---------------|----------------|----------------|----------------|
| Source of funds | | | | | | | | | |
| Shareholders funds | 39,552 | 42,209 | 44,057 | 44,676 | 47,451 | 66,441 | 68,069 | 71,177 | 75,861 |
| Capital | 2,143 | 2,755 | 2,755 | 2,755 | 2,755 | 3,458 | 3,458 | 3,588 | 3,668 |
| Reserves and surplus | 37,409 | 39,454 | 41,302 | 41,922 | 42,996 | 60,413 | 62,041 | 66,809 | 70,992 |
| Share application / warrant | | | | | 1,700 | 2,570 | 2,570 | 780 | 1,200 |
| Loan funds | 38,162 | 39,478 | 40,551 | 41,433 | 43,475 | 32,711 | 33,512 | 40,517 | 40,486 |
| Deferred tax liability | 16 | 18 | 21 | 24 | 27 | 30 | 40 | 53 | 54 |
| | 77,730 | 81,705 | 84,629 | 86,134 | 90,953 | 99,183 | 101,621 | 111,748 | 116,401 |
| Application of funds | | | | | | | | | |
| Fixed assets | 614 | 648 | 669 | 728 | 979 | 1,009 | 1,412 | 1,830 | 1,708 |
| Gross block | 569 | 583 | 594 | 629 | 924 | 952 | 1,425 | 1,905 | 1,793 |
| Less: Depreciation | 31 | 36 | 40 | 49 | 57 | 66 | 77 | 98 | 94 |
| Net block | 538 | 547 | 554 | 580 | 867 | 886 | 1,348 | 1,807 | 1,699 |
| Capital work-in-progress | 76 | 100 | 115 | 147 | 111 | 123 | 65 | 23 | 9 |
| Investment | 2,810 | 4,107 | 4,362 | 3,029 | 4,871 | 5,078 | 5,032 | 5,965 | 6,337 |
| Current assets | 82,242 | 87,035 | 86,611 | 88,673 | 92,455 | 99,638 | 102,218 | 112,299 | 120,694 |
| Inventories | 54,448 | 55,834 | 62,263 | 64,417 | 68,053 | 71,795 | 75,577 | 80,337 | 87,311 |
| Sundry Debtors | 572 | 1,686 | 1,530 | 1,654 | 2,219 | 3,309 | 2,274 | 2,007 | 3,645 |
| Cash and bank balances | 3,484 | 4,016 | 972 | 752 | 582 | 1,103 | 1,006 | 7,874 | 5,155 |
| Loans and advances | 23,738 | 25,498 | 21,847 | 21,850 | 21,601 | 23,431 | 23,361 | 22,081 | 24,583 |
| Less: Current liabilities and provisions | 8,065 | 10,205 | 7,013 | 6,296 | 7,352 | 6,542 | 7,041 | 8,345 | 12,339 |
| Liabilities | 6,632 | 9,392 | 6,849 | 6,115 | 7,070 | 6,532 | 7,002 | 8,023 | 11,623 |
| Provisions | 1,433 | 813 | 165 | 181 | 282 | 10 | 40 | 323 | 716 |
| Misc. expenditure | 128 | 121 | | | | | | | |
| | 77,730 | 81,705 | 84,629 | 86,134 | 90,953 | 99,183 | 101,621 | 111,748 | 116,401 |
| Key ratios | | | | | | | | | |
| Debt/Equity | 1.0 | 0.9 | 0.9 | 0.9 | 0.9 | 0.5 | 0.5 | 0.6 | 0.5 |
| Net debt/Equity | 0.9 | 0.8 | 0.9 | 0.9 | 0.9 | 0.5 | 0.5 | 0.5 | 0.5 |
| Growth in inventory (%) qoq | 6.7% | 2.5% | 11.5% | 3.5% | 5.6% | 5.5% | 5.3% | 6.3% | 8.7% |

Source: Company, Kotak Institutional Equities estimates

Our estimate of HDIL's NAV is ₹353/share
NAV-based valuation, HDIL, March fiscal year-ends (₹ bn)

| | NAV calculation | | | |
|--|-------------------------------|------------|------------|------------|
| | Growth rate in selling prices | | | |
| | 0% | 3% | 5% | 10% |
| Valuation (Rs bn) | 76 | 93 | 105 | 140 |
| Residential projects | 35 | 47 | 55.6 | 82 |
| Commercial/retail projects | 27 | 30 | 32.6 | 39 |
| Slum rehabilitation projects | 14 | 16 | 16.6 | 19 |
| Add: BKC rental property | 1.5 | 1.5 | 1.5 | 1.5 |
| Add: Money to be received from promoters | 6.8 | 6.8 | 6.8 | 6.8 |
| Net debt | (33.0) | (33.0) | (33.0) | (33.0) |
| Add: Mumbai slum rehabilitation project | 60.4 | 60.4 | 60.4 | 60.4 |
| NAV (Rs bn) | 112 | 128 | 140 | 176 |
| Total no of shares | | | | 397.8 |
| NAV/share | | | | 353 |
| Target price @10% discount to NAV | | | | 318 |

Source: Company, Kotak Institutional Equities estimates

Profit model of HDIL

March fiscal year-ends, 2008-2013E (₹ mn)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|-----------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Total revenues | 23,804 | 17,193 | 15,021 | 18,460 | 29,279 | 44,630 |
| Land/Construction costs | (6,336) | (8,304) | (1,414) | (6,311) | (11,072) | (13,050) |
| Employee costs | (122) | (199) | (285) | (421) | (484) | (629) |
| SG&A costs | (431) | (886) | (658) | (554) | (878) | (1,339) |
| EBITDA | 16,914 | 7,804 | 12,664 | 11,174 | 16,845 | 29,612 |
| Other income | 529 | 953 | 345 | 345 | 345 | 345 |
| Interest | (1,408) | (580) | (5,234) | (2,098) | (4,736) | (4,646) |
| Depreciation | (15) | (24) | (723) | (74) | — | (624) |
| Pretax profits | 16,021 | 8,153 | 7,052 | 9,347 | 12,455 | 24,687 |
| Profit/(loss) share of associates | — | — | — | — | — | — |
| Current tax | (1,910) | (932) | (1,302) | (2,321) | (4,192) | (8,363) |
| Deferred tax | (7) | (9) | (27) | (16) | — | 53 |
| Net income | 14,103 | 7,212 | 5,723 | 7,010 | 8,262 | 16,377 |
| EPS (Rs) | | | | | | |
| Primary | 53.8 | 26.2 | 15.9 | 18.2 | 21.5 | 39.9 |
| Fully diluted | 53.8 | 26.2 | 15.9 | 18.2 | 21.5 | 39.9 |
| Shares outstanding (mn) | | | | | | |
| Year end | 275 | 275 | 359 | 385 | 385 | 385 |
| Primary | 262 | 275 | 359 | 385 | 385 | 385 |
| Fully diluted | 262 | 275 | 359 | 385 | 385 | 385 |
| Cash flow per share (Rs) | | | | | | |
| Primary | 53 | 24 | 19 | 12 | 21 | 40 |
| Fully diluted | 53 | 24 | 19 | 12 | 21 | 40 |
| Growth (%) | | | | | | |
| Net income (adjusted) | 160 | (49) | (21) | 22 | 18 | 98 |
| EPS (adjusted) | 130 | (51) | (39) | 14 | 18 | 86 |
| DCF/share | 104 | (54) | (19) | (38) | 70 | 96 |
| Cash tax rate (%) | 12 | 11 | 18 | 25 | 34 | 34 |
| Effective tax rate (%) | 12 | 12 | 19 | 25 | 34 | 34 |

Source: Company, Kotak Institutional Equities estimates

Balance sheet of HDIL

March fiscal year-ends, 2008-2013E (Rs mn)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|--------------------------------|---------------|---------------|----------------|----------------|----------------|----------------|
| Equity | | | | | | |
| Share capital | 2,143 | 2,755 | 3,588 | 3,848 | 3,848 | 4,108 |
| Reserves/surplus | 34,272 | 41,463 | 66,060 | 76,856 | 82,924 | 99,301 |
| Total equity | 36,415 | 44,218 | 70,429 | 80,705 | 86,772 | 103,410 |
| Deferred tax liability/(asset) | 15 | 24 | 51 | 67 | 67 | 14 |
| Liabilities | | | | | | |
| Secured loans | 19,461 | 40,933 | 41,017 | 39,965 | 38,965 | 38,465 |
| Unsecured loans | 11,667 | 500 | — | — | — | — |
| Total borrowings | 31,127 | 41,433 | 41,017 | 39,965 | 38,965 | 38,465 |
| Current liabilities | 7,477 | 6,693 | 8,761 | 20,527 | 37,661 | 66,502 |
| Total capital | 75,034 | 92,368 | 120,258 | 141,263 | 163,465 | 208,391 |
| Assets | | | | | | |
| Cash | 3,505 | 755 | 7,918 | 6,992 | 6,183 | 29,762 |
| Current assets | 68,903 | 87,894 | 105,274 | 125,581 | 146,045 | 167,503 |
| Gross block | 576 | 654 | 1,937 | 2,165 | 6,781 | 7,294 |
| Less: accumulated depreciation | 32 | 56 | 107 | 181 | 181 | 805 |
| Net fixed assets | 544 | 598 | 1,830 | 1,984 | 6,600 | 6,489 |
| Capital work-in-progress | 52 | 152 | 217 | 1,687 | (383) | (383) |
| Total fixed assets | 596 | 749 | 2,047 | 3,671 | 6,217 | 6,106 |
| Intangible assets | | | | | | |
| Investments | 2,006 | 2,969 | 5,020 | 5,020 | 5,020 | 5,020 |
| Misc. expenses | 24 | — | — | — | — | — |
| Total assets | 75,034 | 92,368 | 120,258 | 141,263 | 163,465 | 208,391 |
| Leverage ratios (%) | | | | | | |
| Debt/equity | 85 | 94 | 58 | 49 | 45 | 37 |
| Debt/capitalization | 46 | 48 | 37 | 33 | 31 | 27 |
| Net debt/equity | 76 | 92 | 47 | 41 | 38 | 8 |
| Net debt/capitalization | 43 | 48 | 32 | 29 | 27 | 8 |
| RoAE | 65 | 18 | 10 | 9 | 10 | (0) |
| RoACE | 39 | 10 | 10 | 7 | 9 | — |

Source: Company, Kotak Institutional Equities estimates

Cash flow for HDIL

March fiscal year-ends, 2008 – 2013E (₹ mn)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|---|-----------------|-----------------|-----------------|----------------|----------------|---------------|
| Operating | | | | | | |
| Pre-tax profits before extraordinary items | 16,021 | 7,715 | 7,052 | 9,347 | 12,455 | 24,687 |
| Depreciation | 15 | 25 | 723 | 74 | — | 624 |
| Taxes paid | (1,637) | (629) | (1,202) | (2,321) | (4,192) | (8,363) |
| Other income | (527) | (471) | (62) | (345) | (345) | (345) |
| Interest expenses | 43 | 582 | 462 | 2,098 | 4,736 | 4,646 |
| Interest paid | (43) | (582) | — | (4,196) | (4,736) | (4,646) |
| Extraordinary items | 7 | 15 | 2 | — | — | — |
| Working capital changes (a) | (53,449) | (18,234) | (16,152) | (6,444) | (3,330) | 7,383 |
| Total operating | (39,569) | (11,579) | (9,177) | (1,787) | 4,587 | 23,987 |
| Operating, excl. working capital (b) | 13,872 | 6,640 | 6,973 | 4,657 | 7,917 | 16,603 |
| Investing | | | | | | |
| Capital expenditure | (455) | (625) | (317) | (1,698) | (2,547) | (513) |
| (Purchase)/Sale of assets/businesses | — | — | (3,079) | — | — | — |
| (Purchase)/Sale of investments | 190 | (101) | 18 | — | — | — |
| Interest/dividend received | — | — | 60 | 345 | 345 | 345 |
| Total investing (c) | (265) | (726) | (3,318) | (1,353) | (2,202) | (167) |
| Financing | | | | | | |
| Proceeds from share issuance / warrants | 17,136 | — | 16,636 | 5,460 | — | 260 |
| Proceeds from borrowings | 27,371 | 10,306 | 3,022 | (1,052) | (1,000) | (500) |
| Dividends paid (d) | (1,230) | (751) | (0) | (2,194) | (2,194) | (0) |
| Total financing | 43,277 | 9,554 | 19,658 | 2,213 | (3,194) | (240) |
| Net increase in cash and cash equivalents | 3,443 | (2,750) | 7,163 | (926) | (809) | 23,579 |
| Beginning cash | 62 | 3,505 | 755 | 7,918 | 6,992 | 6,183 |
| Ending cash | 3,505 | 755 | 7,918 | 6,992 | 6,183 | 29,762 |
| Gross cash flow (b) | 13,872 | 6,640 | 6,973 | 4,657 | 7,917 | 16,603 |
| Free cash flow (b) + (a) + (c) | (39,841) | (12,320) | (12,497) | (3,139) | 2,386 | 23,819 |
| Excess cash flow (b) +(a) + (c) + (d) | (41,071) | (13,071) | (12,497) | (5,334) | 191 | 23,819 |

Source: Company, Kotak Institutional Equities estimates

JULY 29, 2010

RESULT

 Coverage view: **Attractive**

 Price (Rs): **378**

 Target price (Rs): **430**

 BSE-30: **17,992**

Another strong quarter. OBC reported another quarter of strong core earnings: 118% growth in NII – margins improved by 7 bps to 3.3% and fee income growth of 30%. With a steadily rising interest rates and upward re-pricing of its liabilities, we believe margins have peaked for the bank with a lower CASA being a structural disadvantage. NPLs were flattish sequentially with a very low slippage ratio of 0.5%. Valuations at 1X FY2012E PBR are attractive. ADD with TP of Rs 430.

Company data and valuation summary

Oriental Bank of Commerce

Stock data

| | |
|-------------------------------|---------|
| 52-week range (Rs) (high,low) | 386-161 |
| Market Cap. (Rs bn) | 94.7 |

Shareholding pattern (%)

| | |
|-----------|------|
| Promoters | 51.1 |
| FIs | 15.0 |
| MFs | 4.6 |

Price performance (%)

| | 1M | 3M | 12M |
|----------------|------|-----|-------|
| Absolute | 16.9 | 9.2 | 127.1 |
| Rel. to BSE-30 | 13.9 | 6.3 | 91.5 |

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|-------|-------|-------|
| EPS (Rs) | 45.3 | 57.8 | 66.8 |
| EPS growth (%) | 25.3 | 27.6 | 15.5 |
| P/E (X) | 8.3 | 6.5 | 5.7 |
| NII (Rs bn) | 29.1 | 39.4 | 45.6 |
| Net profits (Rs bn) | 11.3 | 14.5 | 16.7 |
| BVPS | 292.2 | 336.4 | 387.4 |
| P/B (X) | 1.3 | 1.1 | 1.0 |
| ROE (%) | 14.5 | 16.5 | 16.9 |
| Div. Yield (%) | 2.4 | 3.1 | 3.5 |

QUICK NUMBERS

- NII growth at 118%
NIMs at 3.3%
- Slippages lower at 0.5% in 1QFY11
- Revising TP to Rs430 (from Rs400 earlier)

NIMs healthy at 3.4% but have peaked; loan growth at 20%

The strong trend in margins and NII being witnessed over last few quarters, continued in 1QFY11 as well - NII in 1QFY11 was Rs10.6 bn (up 118% yoy) and 13% higher than our expectations. This as driven by a 20% loan book growth to Rs 861 bn and 150 bps margin improvement over 1QFY10. Incremental loan growth during the quarter was 2% or Rs20 bn. Margins improved further to 3.34% in 1QFY11, as against 3.27% in 4QFY10 and 1.83% in 1QFY10. We believe that margins have already reached peak levels (with nearly Rs900 bn of low-cost term deposits being re-priced) and likely to trend lower from hereon, as rising short-term loans begin to have an impact on deposit costs; however, a decline in margins is likely to be gradual.

Asset quality performance is the best amongst all public banks

OBC reported the best performance thus far on asset quality with a slippage of just 0.5% during the quarter. We believe that its aggressive NPL recognition during 4QFY10 helped asset quality during the current quarter. Gross NPLs of OBC were Rs15 bn (1.7%) as of June 2010, flattish sequentially. Net NPLs declined from Rs7.3 bn to Rs6.2 bn sequentially on back of recoveries and high NPL provisions. The restructured loans of the bank also declined to Rs53 bn (6.2% of overall loans) from Rs58 bn as of March 2010.

Fee income impressive at 30% yoy; treasury income declines sharply

OBC's non-interest revenues were Rs2.1 bn in 1QFY11 (down 45% yoy) due to lower treasury income despite strong fee income growth. Core fees grew 30% yoy, driven by a combination of volumes/pricing and contribution from new streams like third party distribution. Treasury gains were at Rs170 mn (down 93% yoy). Income from written-off assets grew by Rs 160 mn for the quarter while exchange income grew by 23% yoy to Rs249 mn.

M B Mahesh
mb.mahesh@kotak.com
Mumbai: +91-22-6634-1231

Manish Karwa
manish.karwa@kotak.com
Mumbai: +91-22-6634-1350

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Other highlights for the quarter

- ▶ Cost-income ratio for the quarter was at 35% compared to 38% in March 2010. The bank has estimated the pension liability at Rs5-6 bn (6% of FY2011E network) but has already made a provision of Rs2.2 bn. Gratuity liability has been estimated at Rs2 bn of which Rs0.5 bn has already been provided in 1QFY10.
- ▶ Capital adequacy ratio stands comfortable at 12.4% with tier-1 ratio at 9.2%.

Raise earnings; stock available at compelling valuations; maintain ADD

We raise our earnings by 9% for FY2011E and 14% for FY2012E, in order to factor in higher margins and strong growth in fee income. The bank has provided partly for pension, gratuity and agri waiver reducing near-term pressure on earnings. Given the higher reliance on short-term deposits, we believe that the margins for the bank to steadily decline from current levels as the liability franchise is relatively weak compared to its peers. We expect the stock to trade higher on the back of strong earnings and compelling valuations. Stock trades at 1.0X FY2012E PBR. We maintain ADD.

We assume about 11% higher earnings for FY2011E and FY2012E

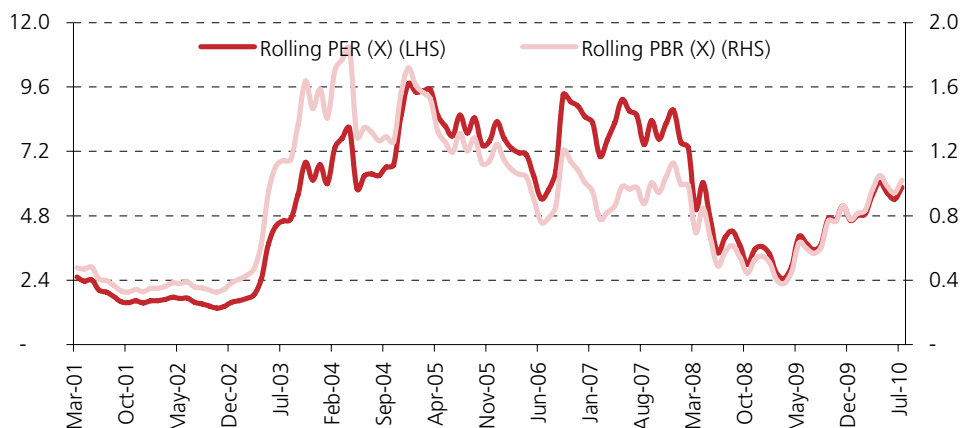
Old and new estimates, March fiscal year-ends, 2011-2012E (Rs mn)

| | Old Estimates | | New Estimates | | % change | |
|-----------------------------|---------------|---------------|---------------|---------------|-------------|-------------|
| | 2011E | 2012E | 2011E | 2012E | 2011E | 2012E |
| Net interest income | 36,853 | 42,592 | 39,387 | 45,626 | 6.9 | 7.1 |
| Advances (Rs bn) | 1,027 | 1,253 | 1,019 | 1,243 | (0.8) | (0.8) |
| NIM (%) | 2.6 | 2.5 | 2.7 | 2.6 | | |
| Loan loss provisions | 6,541 | 7,981 | 7,414 | 7,915 | 13.3 | (0.8) |
| Other income | 10,243 | 11,322 | 10,180 | 11,456 | (0.6) | 1.2 |
| Fee income | 6,775 | 7,791 | 6,694 | 7,698 | (1.2) | (1.2) |
| Treasury income | 1,500 | 1,500 | 1,200 | 1,200 | (20.0) | (20.0) |
| Operating expenses | 20,106 | 23,353 | 19,540 | 22,696 | (2.8) | (2.8) |
| Employee expenses | 10,821 | 12,053 | 10,823 | 12,059 | 0.0 | 0.0 |
| Investment dep/amortization | 1,000 | 1,000 | 1,000 | 1,500 | | |
| PBT | 19,449 | 21,580 | 21,613 | 24,971 | 11.1 | 15.7 |
| Net profit | 13,225 | 14,674 | 14,475 | 16,724 | 9.5 | 14.0 |

Source: Company, Kotak Institutional Equities estimates

Oriental Bank of Commerce - Rolling PBR and PER

March 2001-July 2010 (X)



Source: Kotak Institutional Equities

OBC, quarterly results

March fiscal year-ends, 1QFY10-1QFY11 (Rs mn)

| | 1QFY10 | 2QFY10 | 3QFY10 | 4QFY10 | 1QFY11 | % chg | 1QFY11E | Actual Vs KS |
|--|--------------|--------------|---------------|---------------|---------------|-------------|---------------|-----------------|
| Interest income | 24,043 | 24,958 | 26,716 | 26,845 | 28,308 | 18 | 27,459 | 3 |
| Loans | 17,860 | 18,698 | 19,517 | 19,590 | 20,844 | 17 | 20,301 | 3 |
| Investments | 5,737 | 5,810 | 6,579 | 6,493 | 6,714 | 17 | 6,561 | 2 |
| Balance with RBI & banks | 442 | 448 | 619 | 587 | 749 | 69 | 587 | 28 |
| Others | 4 | 2 | — | 176 | 1 | (71) | 10 | (88) |
| Interest expense | 19,201 | 19,348 | 17,987 | 16,961 | 17,736 | (8) | 18,110 | (2) |
| Net interest income | 4,843 | 5,610 | 8,729 | 9,884 | 10,572 | 118 | 9,349 | 13 |
| Non-int.income | 3,919 | 3,051 | 2,377 | 2,664 | 2,147 | (45) | 3,057 | (30) |
| Other income ex treasury | 1,556 | 2,004 | 1,867 | 2,389 | 1,978 | 27 | 2,111 | (6) |
| Sale of invts. | 2,363 | 1,047 | 510 | 275 | 170 | (93) | 945 | (82) |
| Total income | 8,762 | 8,661 | 11,106 | 12,548 | 12,720 | 45 | 12,406 | 3 |
| Op. expenses | 3,591 | 3,612 | 4,878 | 4,779 | 4,497 | 25 | 4,908 | (8) |
| Employee cost | 1,995 | 1,967 | 2,891 | 2,859 | 2,631 | 32 | 2,993 | (12) |
| Other cost | 1,596 | 1,645 | 1,986 | 1,919 | 1,866 | 17 | 1,916 | (3) |
| Operating profit | 5,170 | 5,049 | 6,228 | 7,769 | 8,223 | 59 | 7,497 | 10 |
| Provisions and cont. | 1,514 | 551 | 1,921 | 4,174 | 2,280 | 51 | 2,770 | (18) |
| Investment depreciation | 180 | (104) | 16 | (155) | 179 | (1) | 270 | (34) |
| NPLs | 1,000 | 378 | 457 | 3,480 | 1,436 | 44 | 2,000 | (28) |
| PBT | 3,657 | 4,497 | 4,307 | 3,595 | 5,943 | 63 | 4,727 | 26 |
| Tax | 1,082 | 1,789 | 1,413 | 425 | 2,310 | 114 | 1,386 | 67 |
| Net profit | 2,575 | 2,708 | 2,894 | 3,170 | 3,633 | 41 | 3,341 | 9 |
| Tax rate (%) | 29.6 | 39.8 | 32.8 | 11.8 | 38.9 | 31.4 | 29.3 | 32.5 |
| Key balance sheet items (Rs bn) | | | | | | | | |
| Deposits | 1,027 | 1,079 | 1,107 | 1,203 | 1,231 | | | |
| CASA | 233 | 255 | 270 | 300 | 300 | | | |
| CASA ratio (%) | 23.5 | 23.7 | 24.4 | 25.0 | 24.3 | | | |
| Advances | 716 | 765 | 786 | 842 | 861 | | | |
| Total retail loans | 95 | 106 | 103 | 108 | | | | |
| Investments | 314 | 323 | 340 | 358 | 375 | | | |
| Other details | | | | | | | | |
| Asset quality details | | | | | | | | |
| Gross NPLs (Rs bn) | 11.5 | 11.8 | 12.9 | 14.7 | 15.0 | | | |
| Gross NPLs (%) | 1.6 | 1.5 | 1.6 | 1.7 | 1.7 | | | |
| Net NPLs (Rs bn) | 5.0 | 5.0 | 5.6 | 7.3 | 6.2 | | | |
| Net NPLs (%) | 0.7 | 0.7 | 0.8 | 0.9 | 0.7 | | | |
| Provision coverage (%) | 56.2 | 57.7 | 56.2 | 50.4 | 58.8 | | | |
| Restructured Assets (Rs bn) | 52.0 | 53.0 | 52.0 | 57.3 | 53.2 | | | |
| % of loan book | 7.3 | 6.9 | 6.6 | 6.8 | 6.2 | | | |
| Yield management measures (%) | | | | | | | | |
| Yield on advances | 10.4 | 10.3 | 10.3 | 10.2 | 10.0 | | | |
| Yield on investments | 7.5 | 6.6 | 6.9 | 7.1 | 7.2 | | | |
| Cost of deposits | 7.4 | 7.1 | 6.2 | 5.7 | 5.6 | | | |
| Net interest margin | 1.83 | 2.02 | 3.00 | 3.27 | 3.34 | | | |

Source: Company, Kotak Institutional Equities

OBC, growth rates and key ratios
March fiscal year-ends, 2008-2013E (%)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|--|------------|------------|------------|------------|------------|------------|
| Growth rates (%) | | | | | | |
| Net loan | 23.6 | 25.5 | 21.9 | 22.0 | 22.0 | 21.3 |
| Customer assets | 22.5 | 24.7 | 20.5 | 21.5 | 21.6 | 21.0 |
| Investments excld. CPs and debentures growth | 23.6 | 20.4 | 29.8 | 24.2 | 20.0 | 19.4 |
| Net fixed assets | 1.2 | 257.2 | 0.7 | 12.0 | 10.8 | 9.8 |
| Cash and bank balance | 36.0 | 19.7 | 19.4 | (3.5) | 4.7 | 3.8 |
| Total Asset | 22.7 | 24.1 | 22.1 | 19.1 | 19.3 | 19.0 |
| Deposits | 21.7 | 26.3 | 22.3 | 20.9 | 20.9 | 20.3 |
| Current | 22.1 | (0.7) | 32.5 | 28.0 | 27.6 | 26.6 |
| Savings | 7.1 | 12.1 | 26.6 | 24.6 | 24.5 | 23.7 |
| Fixed | 25.8 | 33.6 | 20.3 | 19.3 | 19.3 | 18.6 |
| Net interest income | (0.5) | 18.7 | 45.6 | 35.5 | 15.8 | 16.0 |
| Loan loss provisions | 4.9 | (274.7) | 159.0 | 31.6 | 6.8 | 21.6 |
| Total other income | 10.1 | 71.4 | 12.0 | (15.2) | 12.5 | 12.8 |
| Net fee income | 8.1 | 22.5 | 42.5 | 17.0 | 15.0 | 15.0 |
| Net capital gains | 38.4 | 213.3 | (12—) | (71.7) | — | — |
| Net exchange gains | 11.2 | 55.8 | (29.2) | 15.0 | 15.0 | 15.0 |
| Operating expenses | 8.2 | 28.1 | 21.9 | 15.9 | 16.1 | 16.1 |
| Employee expenses | 5.5 | 37.6 | 28.5 | 11.4 | 11.4 | 11.4 |
| Key ratios (%) | | | | | | |
| Yield on average earning assets | 8.6 | 9.0 | 8.5 | 8.6 | 8.8 | 9.0 |
| Yield on average loans | 9.8 | 10.6 | 10.0 | 10.1 | 10.1 | 10.3 |
| Yield on average investments | 8.6 | 8.3 | 7.8 | 8.0 | 8.1 | 8.1 |
| Average cost of funds | 6.9 | 7.4 | 6.5 | 6.3 | 6.6 | 6.8 |
| Interest on deposits | 6.9 | 7.4 | 6.4 | 6.2 | 6.5 | 6.8 |
| Difference | 1.7 | 1.6 | 2.0 | 2.3 | 2.3 | 2.2 |
| Net interest income/earning assets | 2.1 | 2.0 | 2.4 | 2.7 | 2.6 | 2.5 |
| Spreads on lending business | 2.9 | 3.2 | 3.5 | 3.8 | 3.6 | 3.5 |
| Spreads on lending business (incl. Fees) | 3.6 | 3.8 | 4.2 | 4.5 | 4.3 | 4.1 |
| New provisions/average net loans | (0.3) | 0.4 | 0.7 | 0.8 | 0.7 | 0.7 |
| Interest income/total income | 72.9 | 65.1 | 70.8 | 79.5 | 79.9 | 80.4 |
| Other income / total income | 27.1 | 34.9 | 29.2 | 20.5 | 20.1 | 19.6 |
| Fee income to total income | 14.2 | 13.1 | 13.9 | 13.5 | 13.5 | 13.4 |
| Fee income to advances | 0.7 | 0.7 | 0.8 | 0.7 | 0.7 | 0.6 |
| Fees income to PBT | 42.3 | 34.6 | 35.6 | 31.0 | 30.8 | 30.7 |
| Net trading income to PBT | (45.4) | 35.1 | 10.6 | 5.6 | 4.8 | 4.2 |
| Exchange inc./PBT | 8.9 | 9.2 | 4.7 | 4.0 | 4.0 | 4.0 |
| Operating expenses/total income | 46.8 | 45.1 | 41.0 | 39.4 | 39.8 | 40.0 |
| Operating expenses/assets | 1.3 | 1.4 | 1.3 | 1.3 | 1.3 | 1.2 |
| Operating profit /AWF | 0.9 | 0.9 | 1.0 | 1.5 | 1.4 | 1.4 |
| Tax rate | 54.4 | 21.9 | 29.3 | 33.0 | 33.0 | 33.0 |
| Dividend payout ratio | 33.3 | 20.2 | 20.1 | 20.1 | 20.1 | 20.1 |
| Share of deposits | | | | | | |
| Current | 10.0 | 7.8 | 8.5 | 9.0 | 9.5 | 10.0 |
| Fixed | 72.1 | 76.3 | 75.0 | 74.0 | 73.0 | 72.0 |
| Savings | 17.9 | 15.9 | 16.5 | 17.0 | 17.5 | 18.0 |
| Loans-to-deposit ratio | 70.1 | 69.6 | 69.4 | 70.0 | 70.7 | 71.3 |
| Equity/assets (EoY) | 6.4 | 6.6 | 6.0 | 5.7 | 5.4 | 5.1 |
| Dupont analysis (%) | | | | | | |
| Net interest income | 2.0 | 2.0 | 2.3 | 2.6 | 2.5 | 2.5 |
| Loan loss provisions | (0.2) | 0.2 | 0.5 | 0.5 | 0.4 | 0.5 |
| Net other income | 0.8 | 1.1 | 1.0 | 0.7 | 0.6 | 0.6 |
| Operating expenses | 1.9 | 1.4 | 1.6 | 1.3 | 1.3 | 1.2 |
| (1- tax rate) | 45.6 | 78.1 | 70.7 | 67.0 | 67.0 | 67.0 |
| ROA | 0.4 | 0.9 | 0.9 | 1.0 | 0.9 | 0.9 |
| Average assets/average equity | 14.5 | 15.4 | 16.0 | 17.2 | 18.1 | 19.1 |
| ROE | 6.2 | 13.7 | 14.5 | 16.5 | 16.9 | 17.2 |

Source: Company, Kotak Institutional Equities estimates

OBC, income statement and balance sheet
March fiscal year-ends, 2008-2013E (Rs mn)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|-----------------------------------|----------------|------------------|------------------|------------------|------------------|------------------|
| Income statement | | | | | | |
| Total interest income | 68,382 | 88,565 | 102,571 | 125,926 | 154,395 | 189,002 |
| Loans | 48,386 | 65,197 | 75,675 | 93,205 | 114,634 | 141,904 |
| Investments | 18,555 | 21,410 | 24,618 | 31,503 | 38,537 | 45,821 |
| Cash and deposits | 1,440 | 1,957 | 2,279 | 1,218 | 1,225 | 1,276 |
| Deposits from customers | 48,956 | 65,319 | 70,282 | 82,493 | 104,724 | 132,050 |
| Net interest income | 16,820 | 19,965 | 29,074 | 39,387 | 45,626 | 52,906 |
| Loan loss provisions | (1,245) | 2,176 | 5,636 | 7,414 | 7,915 | 9,627 |
| Net interest income (after prov.) | 18,065 | 17,789 | 23,438 | 31,973 | 37,711 | 43,279 |
| Other income | 6,250 | 10,715 | 12,000 | 10,180 | 11,456 | 12,917 |
| Net fee income | 3,277 | 4,015 | 5,721 | 6,694 | 7,698 | 8,853 |
| Net capital gains | 1,537 | 4,814 | 4,236 | 1,200 | 1,200 | 1,200 |
| Net exchange gains | 688 | 1,072 | 759 | 873 | 1,004 | 1,155 |
| Operating expenses | 10,796 | 13,828 | 16,860 | 19,540 | 22,696 | 26,357 |
| Employee expenses | 5,494 | 7,562 | 9,713 | 10,823 | 12,059 | 13,433 |
| Depreciation on investments | 755 | 2,336 | (5) | 1,000 | 1,500 | 1,000 |
| Other Provisions | 5,049 | 738 | 2,529 | — | — | — |
| Pretax income | 7,742 | 11,601 | 16,055 | 21,613 | 24,971 | 28,839 |
| Tax provisions | 4,210 | 2,546 | 4,708 | 7,138 | 8,247 | 9,524 |
| Net Profit | 3,532 | 9,054 | 11,347 | 14,475 | 16,724 | 19,315 |
| % growth | (39.2) | 156.3 | 25.3 | 27.6 | 15.5 | 15.5 |
| Operating profit | 6,960 | 9,122 | 11,814 | 21,413 | 25,271 | 28,639 |
| % growth | (33.3) | 31.1 | 29.5 | 81.2 | 18.0 | 13.3 |
| Balance sheet | | | | | | |
| Balance with banks | 19,914 | 44,069 | 64,776 | 64,776 | 64,776 | 64,776 |
| Net value of investments | 239,507 | 284,890 | 357,853 | 439,684 | 523,742 | 621,784 |
| Govt. and other securities | 205,866 | 249,245 | 327,530 | 410,654 | 494,712 | 592,754 |
| Shares | 4,983 | 4,477 | 5,207 | 5,207 | 5,207 | 5,207 |
| Debentures and bonds | 22,783 | 23,988 | 19,256 | 19,256 | 19,256 | 19,256 |
| Net Owned assets | 3,875 | 13,839 | 13,940 | 15,607 | 17,290 | 18,983 |
| Other assets | 15,866 | 19,843 | 21,624 | 21,624 | 21,624 | 21,624 |
| Total assets | 907,053 | 1,125,826 | 1,374,310 | 1,636,467 | 1,952,820 | 2,323,253 |
| Deposits | 778,567 | 983,688 | 1,202,576 | 1,454,302 | 1,758,460 | 2,114,674 |
| Borrowings and bills payable | 52,029 | 31,391 | 53,283 | 53,283 | 53,283 | 53,283 |
| Other liabilities | 18,698 | 36,712 | 36,071 | 36,071 | 36,071 | 36,071 |
| Total liabilities | 849,294 | 1,051,791 | 1,291,930 | 1,543,657 | 1,847,815 | 2,204,029 |
| Paid-up capital | 2,505 | 2,505 | 2,505 | 2,505 | 2,505 | 2,505 |
| Reserves & surplus | 55,254 | 71,529 | 79,874 | 90,304 | 102,500 | 116,719 |
| Total shareholders' equity | 57,759 | 74,034 | 82,379 | 92,810 | 105,005 | 119,224 |

Source: Company, Kotak Institutional Equities estimates

JULY 29, 2010

RESULT, CHANGE IN RECO.

Coverage view: **Attractive**

Price (Rs): **118**

Target price (Rs): **125**

BSE-30: **17,957**

Near-term pain, likely recovery in 2HFY11E. Confluence of factors resulted in earnings miss in 1QFY11, (1) impact of higher priced tea inventory, (2) inherent price-taker status in Eight O' Clock coffee and (3) higher adspends and investments in new categories. We downgrade TGB to ADD from BUY as (1) stock has delivered 13% and 24% outperformance over last 3 and 12 months and (2) limited upside to our target price of Rs125. Key trigger to watch - JV with Pepsi (for 'Himalayan' water, in our view).

Company data and valuation summary

Tata Global Beverages

| Stock data | | Forecasts/Valuations | | | |
|---------------------------------|-----------------|----------------------|-------|-------|------|
| | | 2010 | 2011E | 2012E | |
| 52-week range (Rs) (high,low) | 125-76 | EPS (Rs) | 6.6 | 7.4 | 8.4 |
| Market Cap. (Rs bn) | 73.1 | EPS growth (%) | 23.4 | 11.1 | 13.8 |
| Shareholding pattern (%) | | P/E (X) | 17.9 | 16.1 | 14.1 |
| Promoters | 35.4 | Sales (Rs bn) | 57.8 | 63.4 | 70.2 |
| FIs | 8.1 | Net profits (Rs bn) | 4.1 | 4.5 | 5.2 |
| MFs | 9.4 | EBITDA (Rs bn) | 7.6 | 8.9 | 9.8 |
| Price performance (%) | | EV/EBITDA (X) | 11.4 | 9.3 | 8.4 |
| Absolute | 1M 3M 12M | ROE (%) | 10.9 | 11.4 | 12.0 |
| | (1.0) 15.5 47.3 | Div. Yield (%) | 1.8 | 2.0 | 2.3 |
| Rel. to BSE-30 | (3.3) 12.6 24.4 | | | | |

Uninspiring performance

On a standalone basis, Tata Global Beverages (TGB) reported net sales of Rs4.5 bn (+8%, KIE estimate Rs4.8 bn), EBITDA of Rs524 mn (-20%, KIE estimate Rs694 mn) and PAT of Rs361 mn (-20%, KIE estimate Rs487 mn).

Sales growth of 8% was primarily led by pricing growth, with volume growth likely ~2% (most of the price increases in early part of CY2009 has anniversaried and there is likely mix deterioration due to consumer trading down). Gross margin was flat at 43%; however, higher other expenditure (likely higher adspends), led to 400 bps decline in EBITDA margin to 11.6%.

On a consolidated basis, net sales grew 8% to Rs13.7 bn, EBITDA declined 16% to Rs1.3 bn and PAT declined 19% to Rs729 mn. The management indicated that on a constant currency basis, the sales growth was 11%. We highlight that 1QFY11 includes Grand acquisition; hence the figures are not strictly comparable on yoy basis. Gross margin dipped 360 bps to 57.2% largely due to higher price of green tea, red tea and coffee globally and timing mismatch between input cost inflation and price hike.

Adspends were higher by 60 bps on the back of launch of Good Earth in Canada, Tetley in USA, entry into Middle East etc. On a segmental basis, tea sales increased 4% and coffee sales increased 12%. Eight O'Clock Coffee (EOC) sales growth was flat during the quarter at US\$50.5 mn and PAT margin declined 380 bps to 6%. In our estimate, Tetley sales increased 15% in Rupee terms.

Downgrade to ADD after 13% and 24% outperformance over last 3 and 12 months

We maintain our EPS estimates of Rs7.4 and Rs8.4 for FY2011E and FY2012E, respectively. We downgrade the stock rating to ADD from BUY as (1) stock has delivered 13% and 24% outperformance over last 3 and 12 months, respectively and (2) limited upside to our target price of Rs125. However, potential for earnings upgrades exists as the company is likely to announce details of JV with Pepsi (for distribution of Himalayan mineral water in overseas markets, in our view).

QUICK NUMBERS

- Market share gains in UK, losses in India
- Downgrade to ADD after 13% and 24% outperformance over last 3 and 12 months

Manoj Menon
manoj.menon@kotak.com
Mumbai: +91-22-6634-1391

Amrita Basu
amrita.basu@kotak.com
Mumbai: +91-22-6634-1147

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Positive triggers are (1) likely utilization of net cash of ~Rs110/share, (2) successful inorganic forays, (3) potential for upside in 'Himalayan' and (4) successful reorganization of businesses resulting in ROCE improvement.

Key worries are (1) higher-than-expected tea commodity prices and any inability to pass on cost increases, (2) limited pricing power for EOC (~20% of consolidated sales), (3) new launches necessitating higher adspends in near term, whereas potential benefits could accrue—if the products are successful—in the medium term.

The company has changed the name to Tata Global Beverages from Tata Tea and has subdivided the equity shares to Re1/share from Rs10/share.

Takeaways from the analyst meet

- ▶ **EOC** – Currently has ~4.5% market share in US. The coffee market is showing slow growth, and market share improvement is largely due to gains from other players. EOC is positioned in the value gourmet segment and has limited pricing power, hence is typically a price taker. To manage input cost inflation, the company has resorted to grammage reduction as against price increase (11 ounce from 12 ounce in a pack). Company attributes missing a promotion in Wal-Mart as the reason for poor sales performance (likely due to unfavorable trade terms, in our view).
- ▶ **Tetley UK** – ~85% of the UK tea market is black tea and this market has declined 12%. TGB has grown by 7% while Unilever sales have declined by 20%. TGB leads market share in the green tea segment at ~40% and Rooibos Red Bush has share of ~30%. TGB has taken three price hikes in the last 15 months to counter input cost inflation.
- ▶ **New launches and market entries**–
 - Tion has been extended to three States in South India and is doing well in Kerala;
 - In the Middle East market, which is dominated by Unilever, the company has launched Tetley with a differentiated packaging;
 - Good Earth and Tetley Infusions have been launched in Canada; and
 - Tetley has been relaunched in USA.
- ▶ **Forex impact** – forex impact during the quarter was to the tune of Rs550 mn (~3% of sales).
- ▶ **Tea and coffee price outlook** – the management indicated that there is softening of tea prices in India but the trend outside India is still showing mixed results. With respect to coffee, prices are firming up, for both Arabica and Robusta.
- ▶ **Grand acquisition, Russia** – TGB acquired a Russian company, Grand in FY2010, which predominantly operates at the low-end of the beverages value chain. It holds 51% in the entity. The company has sales of ~USD100 mn and margins of ~11%, in line with TGB margins.
- ▶ **Cash position** – the company has net cash position of Rs7 bn as of June 2010 (Rs110/share).

Interim standalone results of Tata Global Beverages Ltd, March fiscal year-end (Rs mn)

| | 1QFY11 | 1QFY11E | 1QFY10 | 4QFY10 | (% chg) | | |
|-----------------------------|--------------|--------------|--------------|--------------|-------------|-------------|-------------|
| | | | | | 1QFY11E | 1QFY10 | 4QFY10 |
| Net sales | 4,510 | 4,809 | 4,178 | 4,083 | (6) | 8 | 10 |
| Total expenditure | (3,986) | (4,115) | (3,527) | (3,751) | (3) | 13 | 6 |
| Material cost | (2,582) | (2,673) | (2,390) | (2,293) | (3) | 8 | 13 |
| Staff cost | (210) | (222) | (237) | (316) | (5) | (11) | (33) |
| Other expenditure | (1,194) | (1,220) | (900) | (1,142) | (2) | 33 | 5 |
| EBITDA | 524 | 694 | 651 | 332 | (24) | (20) | 58 |
| OPM (%) | 11.6 | 14.4 | 15.6 | 8.1 | | | |
| Other income | 83 | 141 | 141 | 628 | | (41) | (87) |
| Interest | (70) | (98) | (111) | (100) | | (37) | (29) |
| Depreciation | (31) | (30) | (30) | (32) | | 6 | (0) |
| Pretax profits | 506 | 706 | 652 | 829 | (28) | (22) | (39) |
| Tax | (144) | (219) | (200) | (296) | | (28) | (51) |
| Net income (adj.) | 361 | 487 | 452 | 533 | (26) | (20) | (32) |
| Extraordinary items | - | - | (22) | 4 | | | |
| Reported PAT | 361 | 487 | 430 | 537 | (26) | (16) | (33) |
| Income tax rate (%) | 28.5 | 31.0 | 30.7 | 35.7 | | | |
| Cost as a % of sales | | | | | | | |
| Material cost | 57.2 | 55.6 | 57.2 | 56.2 | | | |
| Staff cost | 4.7 | 4.6 | 5.7 | 7.7 | | | |
| Other expenditure | 26.5 | 25.4 | 21.5 | 28.0 | | | |

Source: Company, Kotak Institutional Equities

Interim consolidated results of Tata Global Beverages Ltd, March fiscal year-end (Rs mn)

| | 1QFY11 | 1QFY10 | 4QFY10 | (%)chg | |
|--|---------------|---------------|---------------|--------------|-------------|
| | | | | 1QFY10 | 4QFY10 |
| Net sales | 13,739 | 12,751 | 15,705 | 8 | (13) |
| Total expenditure | (12,432) | (11,202) | (13,968) | 11 | (11) |
| Material cost | (5,879) | (5,000) | (6,324) | 18 | (7) |
| Staff cost | (1,502) | (1,453) | (1,750) | 3 | (14) |
| Advertising and promotion | (2,172) | (2,095) | (2,579) | 4 | (16) |
| Other expenditure | (2,879) | (2,654) | (3,315) | 8 | (13) |
| EBITDA | 1,307 | 1,549 | 1,737 | (16) | (25) |
| OPM (%) | 9.5 | 12.1 | 11.1 | | |
| Other income | 105 | 251 | 44 | (58) | 136 |
| Interest | (115) | (53) | (30) | 120 | 291 |
| Depreciation | (243) | (245) | (272) | (1) | (11) |
| Pretax profits | 1,054 | 1,503 | 1,480 | (30) | (29) |
| Tax | (325) | (604) | (386) | (46) | (16) |
| Net income | 729 | 898 | 1,094 | (19) | (33) |
| Extraordinary items | (273) | (1,094) | (792) | (75) | (66) |
| Reported PAT | 456 | (196) | 302 | (333) | 51 |
| Income tax rate (%) | 30.8 | 40.2 | 26.1 | | |
| Cost as a % of sales | | | | | |
| Material cost | 42.8 | 39.2 | 40.3 | | |
| Staff cost | 10.9 | 11.4 | 11.1 | | |
| Advertising and promotion | 15.8 | 16.4 | 16.4 | | |
| Other expenditure | 21.0 | 20.8 | 21.1 | | |
| Segment results of Tata Tea Ltd | | | | | |
| Revenue | | | | | |
| Tea | 10,143 | 9,739 | 11,908 | 4 | (15) |
| Coffee & Other Produce | 3,436 | 3,060 | 3,560 | 12 | (3) |
| Others | 219 | 156 | 263 | 41 | (17) |
| Unallocated | 2 | 1 | 2 | 23 | (24) |
| EBIT | | | | | |
| Tea | 937 | 1,565 | 1,682 | (40) | (44) |
| Coffee | 584 | 514 | 779 | 14 | (25) |
| Others | (31) | (67) | (5) | (54) | 524 |
| EBIT Margin (%) | | | | | |
| Tea | 9.2 | 16.1 | 14.1 | | |
| Coffee | 17.0 | 16.8 | 21.9 | | |
| Others | (14.3) | (43.3) | (1.9) | | |
| Capital Employed | | | | | |
| Tea | 27,883 | 29,077 | 26,911 | (4) | 4 |
| Coffee | 14,909 | 13,739 | 15,318 | 9 | (3) |
| Others | 232 | 209 | 213 | 11 | 9 |
| Unallocated | 6,365 | 7,164 | 5,362 | (11) | 19 |

Source: Company, Kotak Institutional Equities

Tea prices softening

Tea auction prices (Rs/kg)

| Month/Year | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | % yoy change (2010 / 2009) |
|--------------------------------|-----------|------------|-------------|-----------|-------------|-----------|-----------|------------|-----------|-----------|-----------|------------|------|-------------------------------|
| January | 92 | 68 | 67 | 74 | 50 | 50 | 55 | 56 | 58 | 62 | 68 | 85 | 95 | 13 |
| February | 89 | 64 | 62 | 69 | 47 | 62 | 50 | 55 | 57 | 57 | 60 | 80 | 87 | 8 |
| March | 80 | 59 | 52 | 56 | 43 | 55 | 46 | 52 | 55 | 58 | 59 | 78 | 74 | (5) |
| April | 84 | 59 | 48 | 57 | 48 | 52 | 55 | 56 | 65 | 69 | 71 | 99 | 80 | (19) |
| May | 75 | 74 | 60 | 63 | 57 | 54 | 62 | 57 | 66 | 67 | 78 | 120 | 89 | (26) |
| June | 76 | 76 | 61 | 61 | 59 | 56 | 64 | 58 | 72 | 71 | 87 | 115 | 96 | (17) |
| July | 75 | 76 | 68 | 66 | 60 | 60 | 66 | 60 | 71 | 70 | 88 | 108 | | |
| August | 73 | 75 | 66 | 62 | 56 | 53 | 68 | 58 | 69 | 66 | 93 | 111 | | |
| September | 71 | 79 | 64 | 59 | 60 | 52 | 71 | 55 | 72 | 69 | 100 | 107 | | |
| October | 69 | 82 | 63 | 49 | 56 | 51 | 69 | 53 | 69 | 67 | 99 | 112 | | |
| November | 72 | 80 | 58 | 54 | 57 | 53 | 68 | 59 | 63 | 69 | 94 | 115 | | |
| December | 68 | 71 | 60 | 59 | 56 | 57 | 65 | 61 | 64 | 74 | 90 | 110 | | |
| Yearly average | 77 | 72 | 61 | 61 | 54 | 55 | 62 | 57 | 65 | 67 | 82 | 103 | | |
| Year-on-year (% change) | 18 | (7) | (16) | 0 | (11) | 1 | 13 | (8) | 15 | 2 | 24 | 25 | | |

Source: Indian Tea Board

Coffee bean prices firm

International coffee bean prices (US cents/lb)

| Month / Year | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | % yoy change (2010 / 2009) |
|--------------------------------|-----------|-----------|-----------|-----------|-----------|------------|------------|------------|------|-------------------------------|
| January | 44 | 54 | 59 | 79 | 101 | 106 | 122 | 108 | 127 | 17 |
| February | 44 | 54 | 60 | 89 | 97 | 104 | 139 | 108 | 123 | 15 |
| March | 50 | 50 | 61 | 101 | 93 | 100 | 136 | 106 | 125 | 18 |
| April | 50 | 52 | 59 | 98 | 94 | 99 | 127 | 112 | 127 | 14 |
| May | 47 | 53 | 60 | 100 | 90 | 100 | 127 | 123 | 128 | 4 |
| June | 46 | 49 | 64 | 96 | 86 | 107 | 131 | 119 | 142 | 19 |
| July | 45 | 51 | 59 | 89 | 89 | 106 | 133 | 113 | | |
| August | 43 | 52 | 57 | 85 | 96 | 108 | 131 | 117 | | |
| September | 48 | 54 | 62 | 79 | 96 | 113 | 127 | 116 | | |
| October | 51 | 52 | 61 | 83 | 96 | 116 | 108 | 121 | | |
| November | 55 | 50 | 68 | 86 | 103 | 114 | 108 | 120 | | |
| December | 52 | 52 | 78 | 87 | 108 | 118 | 103 | 125 | | |
| Yearly average | 48 | 52 | 62 | 89 | 96 | 108 | 124 | 116 | | |
| Year-on-year (% change) | | 9 | 20 | 44 | 7 | 12 | 15 | (7) | | |

Source: International Coffee Organisation

Tata Tea: Consolidated profit model, balance sheet, cash model 2006-2012E, March fiscal year-ends (Rs mn)

| | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E |
|-------------------------------------|---------------|---------------|---------------|---------------|---------------|----------------|
| Profit model (Rs mn) | | | | | | |
| Net sales | 40,249 | 43,096 | 48,479 | 57,830 | 63,406 | 70,216 |
| EBITDA | 6,846 | 6,820 | 6,243 | 6,837 | 8,002 | 8,797 |
| Other income | 669 | 539 | 500 | 720 | 922 | 957 |
| Interest | (2,614) | (2,074) | (448) | (279) | 32 | 43 |
| Depreciation | (967) | (916) | (987) | (1,029) | (1,068) | (1,339) |
| Extraordinary items | 1,724 | 16,224 | 7,255 | (191) | 0 | 0 |
| Pretax profits | 5,657 | 20,593 | 12,563 | 6,058 | 7,888 | 8,459 |
| Tax | (1,076) | (1,343) | (1,477) | (2,124) | (2,670) | (2,754) |
| Net profits | 4,581 | 19,250 | 11,086 | 3,933 | 5,218 | 5,705 |
| Earnings per share (Rs) | 4.7 | 4.7 | 5.4 | 6.6 | 7.4 | 8.4 |
| Dividend per share (Rs) | 1.5 | 3.5 | 1.7 | 2.2 | 2.4 | 2.7 |
| Balance sheet (Rs mn) | | | | | | |
| Total equity | 21,722 | 34,142 | 36,310 | 38,652 | 41,465 | 44,664 |
| Total borrowings | 45,778 | 26,093 | 24,311 | 22,741 | 20,864 | 19,163 |
| Current liabilities | 17,326 | 24,229 | 27,088 | 28,791 | 34,701 | 37,531 |
| Total liabilities and equity | 84,825 | 84,465 | 87,708 | 90,184 | 97,031 | 101,358 |
| Cash | 1,188 | 13,232 | 10,892 | 8,833 | 10,293 | 10,178 |
| Current assets | 12,627 | 20,054 | 34,974 | 40,516 | 46,137 | 51,109 |
| Total fixed assets | 64,889 | 37,268 | 38,330 | 38,122 | 37,887 | 37,358 |
| Investments | 6,122 | 13,910 | 3,513 | 2,713 | 2,713 | 2,713 |
| Total assets | 84,825 | 84,465 | 87,708 | 90,184 | 97,031 | 101,358 |
| Key assumptions | | | | | | |
| Revenue growth (%) | 29.6 | 7.1 | 12.5 | 19.3 | 9.6 | 10.7 |
| EBITDA margin(%) | 17.0 | 15.8 | 12.9 | 11.8 | 12.6 | 12.5 |
| EBITDA growth (%) | 25.5 | (0.4) | (8.5) | 9.5 | 17.0 | 9.9 |
| EPS growth (%) | (90.9) | (1.2) | 14.7 | 23.4 | 11.1 | 13.8 |

Source: Kotak Institutional Equities estimates

Continues to impress. Andhra Bank's reported net profit of Rs 3.2 bn (25% growth yoy) was driven by impressive margins (3.7%), core fee income growth (39% yoy) and lower loan loss provisions. Operating costs were higher mainly due to higher retirement provisions. Slippages were low at 1%. Margins are expected to tend downwards but pricing power can check pace of erosion. The bank is trading at 1.1X FY2012 PBR. We increase earnings by 8% in FY2011E and revise our TP to Rs180. Maintain BUY.

Company data and valuation summary

Andhra Bank

Stock data

| | |
|-------------------------------|--------|
| 52-week range (Rs) (high,low) | 152-80 |
| Market Cap. (Rs bn) | 68.0 |

Shareholding pattern (%)

| | |
|-----------|------|
| Promoters | 51.5 |
| FIs | 12.9 |
| MFs | 2.7 |

Price performance (%)

| | 1M | 3M | 12M |
|----------------|-----|------|------|
| Absolute | 6.0 | 10.0 | 57.0 |
| Rel. to BSE-30 | 3.3 | 7.0 | 32.4 |

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|------|-------|-------|
| EPS (Rs) | 21.6 | 22.9 | 26.7 |
| EPS growth (%) | 60.1 | 6.4 | 16.4 |
| P/E (X) | 6.5 | 6.1 | 5.3 |
| NII (Rs bn) | 21.9 | 28.6 | 32.5 |
| Net profits (Rs bn) | 10.5 | 11.1 | 13.0 |
| BVPS | 90.9 | 107.6 | 127.1 |
| P/B (X) | 1.5 | 1.3 | 1.1 |
| ROE (%) | 26.0 | 23.1 | 22.7 |
| Div. Yield (%) | 3.6 | 3.8 | 4.4 |

Loan book flat qoq; focus on SME continues

Andhra Bank's loan book as of June 2010 was Rs571 bn (up 27% yoy and 1% qoq). The key sub-segments that witnessed sharp growth were the riskier asset classes like SME (up 47% yoy and 6% qoq), retail (up 37% yoy). Share of SME loans has increased to 15% of loans in June 2011 from 13% of loans in June 2010. The focus on retail and SME has enabled them to increase lending yields, helping the bank improve margins for the quarter.

Margins impressive at 3.7%; improves 28 bps qoq

A combination of factors led by (1) increasing lending yields, (2) improving CD ratio, and (3) declining funding costs led to a sharp improvement of 28 bps qoq in NIMs to 3.7%. Net interest income grew by 67% yoy to Rs7.4 bn. Andhra Bank's cost of deposits declined by 10 bps qoq (despite the impact of higher interest on savings deposits) to 5.5%. CASA ratio was maintained for the quarter at 29%. Lending yields improved by 30 bps qoq while CD ratio expanded by 375 bps qoq to 77%. We believe that margins are at its peak and the bank would see pressure in maintaining at current levels as interest rates are showing upward trends. We are factoring margins to decline by 20 bps to 2.7% (KS calculated) and loan book growth of 19% CAGR over FY2011-12E.

Slippages at 1% witnessed in the quarter; provision coverage (ex write-off) comfortable at 71%

Andhra Bank's gross NPLs increased by 61% yoy (19% qoq) to Rs5.8 bn as of June 2010, with slippages mainly from the restructured portfolio. Slippages for the quarter was at 100 bps compared 20 bps in 1QFY10 and 160 bps in 4QFY10. Provision coverage was comfortable at 71% (inc. write-off at 86%). We currently model loan loss provisions at 70 bps (12 bps in 1QFY11) in FY2011E to factor credit risk, especially given the higher exposure to SME. Restructured book has remained flat qoq at Rs30 bn (5% of loans).

BUY

JULY 29, 2010

RESULT

Coverage view: **Attractive**

Price (Rs): **140**

Target price (Rs): **180**

BSE-30: **17,992**

QUICK NUMBERS

- NII growth 67% yoy
NIM touch 3.7%
- Slippages at 1%;
lower to peers
- Revising TP to Rs
180 (from Rs 160)

M B Mahesh
mb.mahesh@kotak.com
Mumbai: +91-22-6634-1231

Manish Karwa
manish.karwa@kotak.com
Mumbai: +91-22-6634-1350

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Higher retirement benefits lead to increase in cost-income ratio

Cost-income ratio for the quarter was at 46% for the quarter compared to 43% in March 2010 but lower than 49% reported in June 2009. The bank has made excess provisions for retirement benefits (25% of staff expenses). The bank has provided (1) Rs300 mn for gratuity, (2) Rs270 mn for provident fund on revised salary expenses, and (3) Rs175 mn for new pension provision (liability is yet to be finalized but estimated at about Rs2.1 bn to be amortized in 3 years at Rs175 mn/quarter).

We sharply increase our near-term earnings

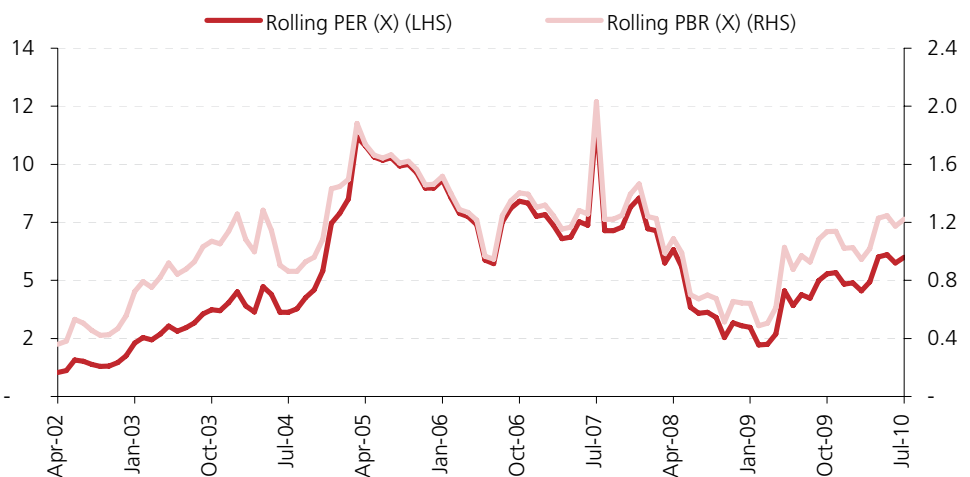
Change in financial parameters, March fiscal year-ends, 2011-2012E

| | Old estimates | | New estimates | | % difference | |
|--------------------------------|---------------|---------------|---------------|---------------|--------------|------------|
| | 2011E | 2012E | 2011E | 2012E | 2011E | 2012E |
| Net interest income | 25,705 | 30,234 | 28,576 | 32,454 | 11.2 | 7.3 |
| Loan growth (%) | 19 | 19 | 19 | 19 | | |
| Spread (%) | 2.4 | 2.3 | 2.8 | 2.6 | | |
| Loan loss provisions | 3,379 | 4,381 | 4,299 | 4,380 | 27.2 | (0.0) |
| Other income | 8,589 | 9,258 | 8,105 | 8,897 | (5.6) | (3.9) |
| Fee income | 2,520 | 2,822 | 2,525 | 2,828 | 0.2 | 0.2 |
| Treasury income | 1,500 | 1,400 | 1,000 | 1,000 | | |
| Operating expenses | 14,227 | 15,644 | 15,152 | 16,939 | 6.5 | 8.3 |
| Employee expenses | 8,584 | 9,334 | 9,488 | 10,387 | 10.5 | 11.3 |
| Net profit | 10,252 | 12,307 | 11,124 | 12,950 | 8.5 | 5.2 |
| PBT-treasury+provisions | 18,567 | 22,448 | 20,530 | 23,412 | 10.6 | 4.3 |

Source: Company, Kotak Institutional Equities estimates

Andhra Bank – Rolling PBR and PER

April 2002-July 2010 (X)



Source: Kotak Institutional Equities

Andhra Bank quarter results

March fiscal year-ends, 1QFY10-1QFY11 (Rs mn)

| | 1QFY10 | 2QFY10 | 3QFY10 | 4QFY10 | 1QFY11 | % chg yoy | 1QFY11 | Actual Vs KS |
|---|--------------|--------------|--------------|--------------|--------------|-------------|----------------|--------------|
| Interest Earned | 15,046 | 15,577 | 16,026 | 17,079 | 18,650 | 24.0 | 17,731.6 | 5.2 |
| Interest on advances | 12,178 | 12,681 | 13,010 | 13,744 | 14,992 | 23.1 | 14,274.5 | 5.0 |
| Interest on investments | 2,809 | 2,797 | 3,004 | 3,273 | 3,570 | 27.1 | 3,377.7 | 5.7 |
| Interest on bal. with RBI & other inter bank fund | 59 | 42 | 12 | 46 | 76 | 29.6 | 45.6 | 66.1 |
| Other interest | — | 58 | — | 17 | 12 | | 33.8 | |
| Interest expense | 10,633 | 10,431 | 10,200 | 10,518 | 11,283 | 6.1 | 11,229.1 | 0.5 |
| Net interest income | 4,414 | 5,146 | 5,825 | 6,562 | 7,367 | 66.9 | 6,502.5 | 13.3 |
| Other income | 2,381 | 2,332 | 2,242 | 2,691 | 2,082 | (12.6) | 1,826.1 | 14.0 |
| Treasury | 1,290 | 950 | 520 | 530 | 480 | (62.8) | 400.0 | 20.0 |
| Income excl treasury | 1,091 | 1,382 | 1,722 | 2,161 | 1,602 | 46.9 | 1,426.1 | 12.3 |
| Total income | 6,794 | 7,478 | 8,068 | 9,253 | 9,449 | 39.1 | 8,328.6 | 13.5 |
| Operating expenses | 3,314 | 2,950 | 3,250 | 3,981 | 4,340 | 31.0 | 3,600.2 | 20.6 |
| Payments to / Provisions for employees | 2,114 | 1,715 | 1,973 | 2,439 | 2,870 | 35.8 | 2,219.6 | 29.3 |
| Other operating expenses | 1,201 | 1,235 | 1,277 | 1,542 | 1,471 | 22.5 | 1,380.7 | 6.5 |
| Operating profit before prov. & cont. | 3,480 | 4,528 | 4,818 | 5,272 | 5,109 | 46.8 | 4,728.3 | 8.0 |
| Provisions & Contingencies | (32) | 578 | 964 | 2,229 | 519 | (1,710.9) | 1,769.4 | (70.7) |
| Loan loss provisions | 380 | 478 | 502 | 1,690 | 174 | (54.2) | 1,300.0 | (86.6) |
| Investment depreciation | (510) | — | — | 70 | — | | | |
| Profit before tax | 3,512 | 3,950 | 3,854 | 3,043 | 4,590 | 30.7 | 2,958.9 | 55.1 |
| Provision for taxes | 950 | 1,210 | 1,100 | 640 | 1,380 | 45.3 | 887.7 | 55.5 |
| Net profit | 2,562 | 2,740 | 2,754 | 2,403 | 3,210 | 25.3 | 2,071.3 | 55.0 |
| Tax rate | 27 | 31 | 29 | | 30 | | | |
| PBT - treasury + investment dep. | 1,712 | 3,000 | 3,334 | 2,583 | 4,110 | 140.0 | 2,558.9 | 60.6 |
| PBT - treasury + investment dep. + loan loss | 2,542 | 3,478 | 3,836 | 4,273 | 4,284 | 68.5 | 3,858.9 | 11.0 |
| Key balance sheet items (Rs bn) | | | | | | | | |
| Deposits | 604 | 623 | 665 | 777 | 747 | 23.7 | | |
| CASA | 185 | 201 | 200 | 229 | 220 | 18.6 | | |
| CASA (%) | 30.7 | 32.3 | 30.0 | 29.5 | 29.4 | | | |
| Advances | 449 | 482 | 514 | 565 | 571 | 27.2 | | |
| Priority sector | 156 | — | — | 190 | 192 | 23.1 | | |
| Agriculture | 69 | 75 | 83 | 91 | 88 | 27.0 | | |
| Retail | 65 | 71 | 79 | 89 | 88 | 36.7 | | |
| SME | 60 | 68 | 76 | 83 | 88 | 46.6 | | |
| Asset quality details | | | | | | | | |
| Gross Non Performing Assets (Rs mn) | 3,591 | 3,984 | 4,469 | 4,879 | 5,793 | 61.3 | | |
| Gross Non Performing Assets (%) | 0.8 | 0.8 | 0.9 | 0.9 | 1.0 | | | |
| Net Non Performing Assets (Rs mn) | 996 | 752 | 879 | 957 | 1,698 | 70.4 | | |
| Net Non Performing Assets (%) | 0.2 | 0.2 | 0.2 | 0.2 | 0.3 | | | |
| Yield management measures (%) | | | | | | | | |
| Yield on advances | 11.2 | 11.2 | 10.9 | 10.6 | 10.9 | | | |
| Cost of deposits | 6.8 | 6.4 | 5.9 | 5.6 | 5.5 | | | |
| Yield on investments | 7.0 | 6.7 | 8.3 | 6.4 | 6.0 | | | |
| Cost of funds | 6.1 | 5.8 | 5.4 | 5.0 | 5.2 | | | |
| Yield from funds | 8.7 | 8.7 | 8.5 | 8.1 | 8.5 | | | |
| Spread | 2.6 | 2.9 | 3.1 | 3.1 | 3.3 | | | |
| NIM | 2.9 | 3.1 | 3.4 | 3.4 | 3.7 | | | |
| Capital adequacy details | | | | | | | | |
| CAR (%) | 14.8 | 14.0 | 14.0 | 13.9 | 13.3 | | | |
| Tier I (%) | 9.1 | 8.9 | 8.9 | 8.2 | 7.8 | | | |
| Tier II (%) | 5.7 | 5.2 | 5.2 | 5.8 | 5.5 | | | |

Source: Company, Kotak Institutional Equities estimates

Andhra Bank key growth rates and Du Pont analysis
March fiscal year-ends, 2008-2013E (%)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|--|------------|------------|------------|------------|------------|------------|
| Growth rates (%) | | | | | | |
| Net loan | 22.8 | 28.9 | 27.1 | 18.9 | 18.8 | 18.8 |
| Customer assets | 21.8 | 28.5 | 25.6 | 18.7 | 18.7 | 18.7 |
| Investments excld. CPs and debentures | 14.5 | 15.3 | 29.1 | 17.4 | 23.6 | 23.2 |
| Net fixed and leased assets | 14.1 | 52.8 | 6.1 | 79.5 | (10.6) | (19.6) |
| Cash and bank balance | 41.5 | (7.1) | 111.2 | 11.2 | 12.0 | 12.8 |
| Total Asset | 19.0 | 21.0 | 31.9 | 17.3 | 18.4 | 18.6 |
| Deposits | 19.3 | 20.1 | 30.8 | 19.9 | 19.9 | 19.8 |
| Current | 20.4 | 18.3 | 29.3 | 26.8 | 19.9 | 19.8 |
| Savings | 14.4 | 10.3 | 19.9 | 22.8 | 19.9 | 19.8 |
| Fixed | 21.0 | 24.0 | 34.6 | 18.2 | 19.9 | 19.8 |
| Net interest income | 0.2 | 14.6 | 34.9 | 30.2 | 13.6 | 14.1 |
| Loan loss provisions | 38.7 | 74.3 | 88.0 | 11.8 | 1.9 | 18.8 |
| Total other income | 20.4 | 22.2 | 26.1 | (16.0) | 9.8 | 12.2 |
| Net fee income | 4.0 | 3.3 | 15.5 | 12.0 | 12.0 | 12.0 |
| Net capital gains | 121.9 | 85.2 | 47.3 | (69.3) | — | 20.0 |
| Net exchange gains | 76.7 | (7.9) | 10.4 | 15.0 | 15.0 | 15.0 |
| Operating expenses | (2.6) | 21.5 | 22.2 | 12.3 | 11.8 | 10.4 |
| Employee expenses | (7.2) | 22.5 | 32.0 | 15.1 | 9.5 | 10.2 |
| Key ratios (%) | | | | | | |
| Yield on average earning assets | 8.5 | 8.9 | 8.3 | 8.2 | 8.3 | 8.4 |
| Yield on average loans | 10.2 | 10.8 | 10.3 | 10.2 | 10.3 | 10.4 |
| Yield on average investments | 7.3 | 7.0 | 6.4 | 6.6 | 6.7 | 6.8 |
| Average cost of funds | 6.0 | 6.5 | 5.6 | 5.4 | 5.7 | 6.0 |
| Interest on deposits | 6.1 | 6.4 | 5.5 | 5.3 | 5.5 | 5.7 |
| Difference | 2.5 | 2.4 | 2.6 | 2.8 | 2.6 | 2.5 |
| Net interest income/earning assets | 2.7 | 2.7 | 2.8 | 3.0 | 2.9 | 2.8 |
| Spreads on lending business | 4.2 | 4.3 | 4.7 | 4.8 | 4.6 | 4.5 |
| Spreads on lending business (incl. Fees) | 4.8 | 4.8 | 5.1 | 5.2 | 5.0 | 4.8 |
| New provisions/average net loans | 0.4 | 0.5 | 0.8 | 0.7 | 0.6 | 0.6 |
| Total provisions/gross loans | 0.9 | 0.7 | 0.7 | 1.2 | 1.6 | 1.9 |
| Interest income/total income | 69.4 | 68.0 | 69.5 | 77.9 | 78.5 | 78.8 |
| Other income / total income | 30.6 | 32.0 | 30.5 | 22.1 | 21.5 | 21.2 |
| Fee income to total income | 9.2 | 8.2 | 7.1 | 6.9 | 6.8 | 6.7 |
| Fee income to advances | 0.6 | 0.5 | 0.4 | 0.4 | 0.4 | 0.4 |
| Fees income to PBT | 20.6 | 21.7 | 15.7 | 15.7 | 15.1 | 14.5 |
| Net trading income to PBT | 11.7 | 4.3 | 25.5 | 1.2 | 1.1 | 1.8 |
| Exchange income to PBT | 6.2 | 5.8 | 4.0 | 4.1 | 4.1 | 4.0 |
| Operating expenses/total income | 44.4 | 46.2 | 42.7 | 41.3 | 41.0 | 39.8 |
| Operating expenses/assets | 1.7 | 1.8 | 1.7 | 1.5 | 1.5 | 1.4 |
| Operating profit /AWF | 1.6 | 1.1 | 1.4 | 1.6 | 1.6 | 1.5 |
| Tax rate | 37.3 | 27.3 | 27.2 | 31.0 | 31.0 | 31.0 |
| Dividend payout ratio | 33.7 | 33.4 | 23.2 | 23.2 | 23.2 | 23.2 |
| Share of deposits | | | | | | |
| Current | 24.6 | 22.6 | 20.7 | 21.2 | 21.2 | 21.2 |
| Fixed | 66.4 | 68.6 | 70.6 | 69.6 | 69.6 | 69.6 |
| Savings | 24.6 | 22.6 | 20.7 | 21.2 | 21.2 | 21.2 |
| Loans-to-deposit ratio | 69.3 | 74.3 | 72.2 | 71.6 | 71.0 | 70.4 |
| Equity/assets (EoY) | 5.7 | 5.3 | 4.9 | 4.9 | 4.9 | 4.9 |
| Dupont analysis (%) | | | | | | |
| Net interest income | 2.7 | 2.6 | 2.8 | 2.9 | 2.8 | 2.7 |
| Loan loss provisions | 0.2 | 0.3 | 0.5 | 0.4 | 0.4 | 0.4 |
| Net other income | 1.2 | 1.2 | 1.2 | 0.8 | 0.8 | 0.7 |
| Operating expenses | 1.8 | 1.8 | 1.7 | 1.6 | 1.5 | 1.4 |
| Inv. depreciation | 0.0 | 0.3 | (0.1) | 0.1 | 0.1 | 0.1 |
| (1- tax rate) | 62.7 | 72.7 | 72.8 | 69.0 | 69.0 | 69.0 |
| ROA | 1.1 | 1.0 | 1.3 | 1.1 | 1.1 | 1.1 |
| Average assets/average equity | 16.3 | 18.1 | 19.7 | 20.4 | 20.3 | 20.4 |
| ROE | 18.0 | 18.9 | 26.0 | 23.1 | 22.7 | 22.4 |

Source: Company, Kotak Institutional Equities estimates

Andhra Bank P&L and balance sheet
March fiscal year-ends, 2008-2013E (Rs mn)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|-----------------------------------|----------------|----------------|----------------|------------------|------------------|------------------|
| Income statement | | | | | | |
| Total interest income | 42,899 | 53,746 | 63,729 | 78,252 | 94,122 | 113,682 |
| Loans | 31,769 | 42,151 | 51,613 | 62,847 | 75,429 | 90,501 |
| Investments | 10,482 | 10,990 | 11,883 | 14,815 | 18,034 | 22,442 |
| Cash and deposits | 647 | 606 | 233 | 590 | 658 | 740 |
| Total interest expense | 28,700 | 37,477 | 41,781 | 49,675 | 61,668 | 76,654 |
| Deposits from customers | 27,778 | 34,871 | 38,014 | 45,341 | 56,269 | 69,998 |
| Net interest income | 14,199 | 16,269 | 21,947 | 28,576 | 32,454 | 37,028 |
| Loan loss provisions | 1,173 | 2,045 | 3,844 | 4,299 | 4,380 | 5,204 |
| Net interest income (after prov.) | 13,025 | 14,224 | 18,103 | 24,278 | 28,074 | 31,824 |
| Other income | 6,262 | 7,650 | 9,646 | 8,105 | 8,897 | 9,979 |
| Net fee income | 1,888 | 1,951 | 2,254 | 2,525 | 2,828 | 3,167 |
| Net capital gains | 1,192 | 2,208 | 3,253 | 1,000 | 1,000 | 1,200 |
| Net exchange gains | 570 | 525 | 580 | 667 | 766 | 881 |
| Operating expenses | 9,091 | 11,043 | 13,495 | 15,152 | 16,939 | 18,709 |
| Employee expenses | 5,094 | 6,241 | 8,241 | 9,488 | 10,387 | 11,443 |
| Depreciation on investments | 925 | 1,820 | (413) | 800 | 800 | 800 |
| Other Provisions | 99 | 35 | 309 | 309 | 464 | 464 |
| Pretax income | 9,176 | 8,980 | 14,359 | 16,122 | 18,768 | 21,831 |
| Tax provisions | 3,420 | 2,450 | 3,900 | 4,998 | 5,818 | 6,768 |
| Net Profit | 5,756 | 6,530 | 10,459 | 11,124 | 12,950 | 15,063 |
| % growth | 7.0 | 13.5 | 60.1 | 6.4 | 16.4 | 16.3 |
| PBT - Treasury + Provisions | 10,181 | 10,673 | 14,845 | 20,530 | 23,412 | 27,099 |
| % growth | 6.9 | 13.8 | 39.2 | 38.3 | 14.0 | 15.8 |
| Balance sheet | | | | | | |
| Cash and bank balance | 56,943 | 52,875 | 111,677 | 124,148 | 139,078 | 156,948 |
| Cash | 4,407 | 4,359 | 4,300 | 4,300 | 4,300 | 4,300 |
| Balance with RBI | 44,610 | 44,174 | 62,687 | 75,158 | 90,088 | 107,958 |
| Balance with banks | 2,443 | 1,947 | 3,338 | 3,338 | 3,338 | 3,338 |
| Net value of investments | 148,982 | 169,111 | 208,810 | 243,566 | 298,821 | 366,117 |
| Govt. and other securities | 130,869 | 152,150 | 197,435 | 232,566 | 287,821 | 355,117 |
| Shares | 2,078 | 1,655 | 1,065 | 1,065 | 1,065 | 1,065 |
| Debentures and bonds | 8,896 | 9,894 | 5,816 | 5,816 | 5,816 | 5,816 |
| Net loans and advances | 342,384 | 441,393 | 561,135 | 667,070 | 792,805 | 942,012 |
| Fixed assets | 2,195 | 3,353 | 3,557 | 6,382 | 5,705 | 4,586 |
| Net Owned assets | 2,195 | 3,353 | 3,557 | 6,382 | 5,705 | 4,586 |
| Other assets | 15,420 | 17,960 | 18,246 | 18,246 | 18,246 | 18,246 |
| Total assets | 565,924 | 684,692 | 903,424 | 1,059,412 | 1,254,655 | 1,487,908 |
| Deposits | 494,365 | 593,900 | 776,882 | 931,440 | 1,116,468 | 1,337,928 |
| Borrowings and bills payable | 24,761 | 41,988 | 67,611 | 60,193 | 60,193 | 60,193 |
| Other liabilities | 14,305 | 12,334 | 14,830 | 15,572 | 16,351 | 17,168 |
| Total liabilities | 533,431 | 648,222 | 859,324 | 1,007,206 | 1,193,012 | 1,415,289 |
| Paid-up capital | 4,850 | 4,850 | 4,850 | 4,850 | 4,850 | 4,850 |
| Reserves & surplus | 27,643 | 31,620 | 39,250 | 47,356 | 56,793 | 67,769 |
| Total shareholders' equity | 32,493 | 36,470 | 44,100 | 52,206 | 61,643 | 72,619 |

Source: Kotak Institutional Equities, Company

JULY 30, 2010
RESULT
Coverage view: Cautious
Price (Rs): 95
Target price (Rs): 86
BSE-30: 17,992

One spot LNG cargo does not make an LNG terminal. We are surprised by the sharp spurt (+11% yesterday) in PLNG stock price—unlike the street, we do not expect PLNG's imported LNG volumes to benefit meaningfully from slower-than-expected ramp-up in gas production at RIL's KG D-6 block. We highlight high inventory levels at PLNG's storage tanks for the past few months. PLNG reported 1QFY11 EBITDA at ₹2.5 bn (+22.5% qoq and +36.3% yoy), 16.7% higher than our estimate of ₹2.1 bn. We maintain our REDUCE rating on the stock with a 12-month DCF-based target price of ₹86.

Company data and valuation summary

Petronet LNG

| Stock data | | Forecasts/Valuations | | | |
|---------------------------------|--------------------------------|----------------------|--------|----------------|-------|
| | | 2010 | 2011E | 2012E | |
| 52-week range (Rs) (high,low) | 96-61 | EPS (Rs) | 5.4 | 5.8 | 7.9 |
| Market Cap. (Rs bn) | 71.2 | EPS growth (%) | (22.0) | 8.1 | 35.3 |
| Shareholding pattern (%) | | P/E (X) | 17.6 | 16.3 | 12.0 |
| Promoters | 50.0 | Sales (Rs bn) | 106.5 | 112.7 | 154.2 |
| FIs | 10.1 | Net profits (Rs bn) | 4.0 | 4.4 | 5.9 |
| MFs | 4.3 | EBITDA (Rs bn) | 8.5 | 9.9 | 12.9 |
| Price performance (%) | 1M 3M 12M | EV/EBITDA (X) | 10.3 | 9.6 | 7.9 |
| Absolute | 21.8 | 20.9 | 36.4 | ROE (%) | 15.9 |
| Rel. to BSE-30 | 18.7 | 17.6 | 15.1 | Div. Yield (%) | 1.8 |
| | | | | | 2.1 |
| | | | | | 2.9 |

Better-than-expected results as re-gasification tariffs surpass expectations

PLNG reported better-than-expected 1QFY11 results with EBITDA at ₹2.5 bn (+22.5% qoq and +36.3% yoy) versus our expected ₹2.1 bn. The higher-than-expected EBITDA was led by higher-than-expected re-gasification tariffs at ₹30.8 mn/BTU versus our expected ₹26.5/mn BTU (₹26.4/mn BTU in 4QFY10). LNG import volume at 95.1 tn BTU (+3.7% qoq and -3.7% yoy) was in line with our expected 94 tn BTU.

Sell into recent strength; opportunistic upgrades by street very convenient

Purported problems at RIL's KG D-6 block have raised hopes about additional import of LNG in FY2011E and FY2012E. However, we (1) note the recent low demand for LNG, which is unrelated to KG D-6 supply issues and (2) remain cautious on the long-term sustainability of PLNG's business model beyond CY2013E due to likely sharp increase in the supply of domestic gas. We are quite surprised by the street's upgrades to DCF valuation based on additional imports of LNG; two years of additional LNG imports (even if assuming so) are unlikely to increase DCF valuations much.

Maintain REDUCE with a revised target price of ₹86; sell into recent strength

We have maintained our REDUCE rating on the stock with a revised 12-month DCF-based target price of ₹86 (₹82 previously) noting (1) the stock offers 9.5% downside to our 12-month target price and (2) likely subdued off-take for imported LNG given pipeline capacity constraints and weak demand over the next few quarters. We note that offtake has been dismal in the past few months with nil spot cargoes and we expect the situation to persist for the next 1-2 quarters.

Earnings revision

We have fine-tuned our EPS estimates for FY2011-13E to ₹5.8 (+5.3%), ₹7.9 (-3.6%) and ₹8.8 (+5.1%). We assume total volumes (contracted plus spot) at 7.8 mn tons for FY2011E, 9.5 mn tons for FY2012E and 11 mn tons for FY2013E. We model PLNG's re-gasification tariff to increase by 5% in each year in FY2011-13E and remain flat thereafter.

QUICK NUMBERS

- Higher re-gasification tariffs at ₹30.8 mn/BTU (+15.6% qoq, +44.5% yoy)
- Ramp-up to 11 mn tons of LNG volumes in FY2013E
- 10% downside to fair value of PLNG from current levels

 Gundeep Singh
 gundeep.singh@kotak.com
 Mumbai: +91-22-6634-1286

 Sanjeev Prasad
 sanjeev.prasad@kotak.com
 Mumbai: +91-22-6634-1229

 Tarun Lakhotia
 tarun.lakhotia@kotak.com
 Mumbai: +91-22-6634-1188

 Kotak Institutional Equities Research
 kotak.research@kotak.com
 Mumbai: +91-22-6634-1100

Does production of KG D-6 gas at 60 mcm/d mean higher volume offtake for PLNG? We will find out

We try to answer this question by analyzing reasons for lower off-take for PLNG’s imported LNG over the past two quarters and see if a lower-than-expected ramp-up from RIL’s KG D-6 block can address those constraints in the future. We hypothesize the following as possible reasons for lower offtake:

- ▶ **Capacity constraints in GAIL’s pipeline.** The management of RIL and Petronet LNG have highlighted capacity constraints in GAIL’s pipeline network for slower-than-expected ramp-up of supply from their respective fields or terminal. We do not see this issue being addressed even with a slower-than expected ramp-up from RIL’s KG D-6 field.
- ▶ **Lack of demand.** The other possible reason for lower offtake could be lower demand for gas from current prospective customers. We believe imported LNG is facing offtake problems as gas from RIL’s KG D-6 gas has ramped up to ~60 mcm/d, exerting pressure on the offtake of more expensive imported LNG. This is corroborated by recent events perhaps missed by enthusiastic analysts—(1) the government requesting RIL to reduce production from KG D-6 field in light of high inventory levels with PLNG and (2) recent movement of GSPC spot cargo from PLNG’s terminal to Shell’s terminal given that PLNG’s storage tanks are currently full. We do not see PLNG benefitting from RIL’s supply problems if it is finding it difficult to reduce its current level of inventories.

We have appended the relevant articles that appeared in industry journals/newspaper highlighting the issue of high level of inventories at PLNG’s storage tanks.

Exhibit 1 gives the details of PLNG’s 1QFY11 results and compares the same with 4QFY10 and 1QFY10 results.

Interim results of Petronet LNG, March fiscal year-ends (₹ mn)

| | 1QFY11 | 1QFY11E | 1QFY10 | 4QFY10 | (% chg.) | | | 2011E |
|------------------------------------|---------------|---------------|---------------|---------------|-------------|--------------|-------------|----------------|
| | | | | | 1QFY11E | 1QFY10 | 4QFY10 | |
| Net sales | 25,260 | 24,350 | 26,124 | 23,855 | 3.7 | (3.3) | 5.9 | 112,693 |
| Total expenditure | (22,782) | (22,227) | (24,306) | (21,833) | 2.5 | (6.3) | 4.4 | (102,800) |
| Raw material | (22,333) | (21,857) | (24,020) | (21,413) | 2.2 | (7.0) | 4.3 | (101,303) |
| Staff cost | (73) | (45) | (41) | (81) | 63.1 | 79.3 | (9.8) | (221) |
| Other expenditure | (376) | (325) | (245) | (339) | 15.8 | 53.3 | 11.1 | (1,276) |
| EBITDA | 2,477 | 2,123 | 1,818 | 2,022 | 16.7 | 36.3 | 22.5 | 9,893 |
| Other income | 126 | 320 | 288 | 332 | (60.6) | (56.3) | (62.0) | 519 |
| Depreciation | (461) | (450) | (256) | (456) | 2.5 | 80.2 | 1.1 | (1,855) |
| Interest | (498) | (525) | (283) | (511) | (5.1) | 75.7 | (2.5) | (2,011) |
| Profit before tax | 1,644 | 1,468 | 1,567 | 1,386 | 12.0 | 4.9 | 18.6 | 6,547 |
| Extraordinary/prior period items | — | — | — | — | | | | — |
| Current tax | (450) | (487) | (520) | (325) | | | | (1,305) |
| Deferred tax liabilities/assets | (80) | — | (12) | (90) | | | | (870) |
| Fringe benefit tax | — | — | (2) | 2 | | | | — |
| Profit after tax | 1,114 | 980 | 1,033 | 973 | 13.6 | 7.8 | 14.5 | 4,372 |
| Adj Profit after tax | 1,114 | 980 | 1,033 | 973 | 13.6 | 7.8 | 14.5 | 4,372 |
| Tax rate (%) | 32.2 | 33.2 | 34.1 | 29.8 | | | | 33.2 |
| Sales quantity (tn BTU) | 95.1 | 94.1 | 98.8 | 91.8 | 1.0 | (3.7) | 3.7 | 397.0 |
| Re-gasification tariff (Rs/mn BTU) | 30.8 | 26.5 | 21.3 | 26.6 | 16.2 | 44.5 | 15.6 | 28.7 |

Source: Company, Kotak Institutional Equities estimates

Key assumptions behind our earnings model

We discuss our key assumptions underlying our earnings assumptions below (see Exhibit 2).

We model Petronet's volumes ramping up to 11 mtpa by FY2013E

Key volume/price assumptions for Petronet LNG, March fiscal year-ends, 2006-14E

| | 2006 | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E | 2014E |
|--|------------|------------|------------|------------|------------|------------|------------|-------------|-------------|
| Volume assumptions | | | | | | | | | |
| Contract LNG volume (mn tons) | 4.8 | 5.1 | 4.8 | 4.8 | 7.1 | 7.5 | 7.5 | 8.0 | 10.0 |
| Spot LNG volume (mn tons) | — | 0.6 | 1.5 | 1.5 | 0.8 | 0.3 | 2.0 | 3.0 | 3.0 |
| Total volumes | 4.8 | 5.6 | 6.3 | 6.3 | 7.9 | 7.8 | 9.5 | 11.0 | 13.0 |
| Price assumptions | | | | | | | | | |
| LNG purchase price (FOB) (US\$/mn BTU) | 2.5 | 3.3 | 3.7 | 4.2 | 4.7 | 4.9 | 5.5 | 5.9 | 5.7 |
| Landed cost (incl. import tariff) (US\$/mn BTU) | 2.9 | 3.8 | 4.2 | 4.7 | 5.3 | 5.5 | 6.2 | 6.6 | 6.5 |
| Base re-gasification charges (US\$/mn BTU) | 0.57 | 0.58 | 0.69 | 0.64 | 0.65 | 0.70 | 0.73 | 0.77 | 0.77 |
| Base re-gasification charges (Rs/mn BTU) | 25.2 | 26.5 | 27.8 | 29.2 | 30.6 | 32.2 | 33.8 | 35.5 | 35.5 |
| Escalation in re-gasification charges (%) | | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | — |
| Sales price (US\$/mn BTU) | 3.5 | 4.4 | 4.9 | 5.4 | 5.9 | 6.2 | 6.9 | 7.4 | 7.3 |
| Other assumptions | | | | | | | | | |
| Rupee/US dollar exchange rate | 44.3 | 45.3 | 40.1 | 45.8 | 47.4 | 46.0 | 46.0 | 46.0 | 46.0 |

Source: Company, Kotak Institutional Equities estimates

- **Volumes.** We model contract LNG volume at 7.5 mn tons, 7.5 mn tons and 8 mn tons in FY2011E, FY2012E and FY2013E. In addition, we model spot LNG imports of 0.3 mn tons in FY2011E, 2 mn tons in FY2012E and 3 mn tons in FY2013E.
- **Re-gasification tariffs.** We model PLNG's re-gasification tariff to increase by 5% in each year in FY2011-13E and remain flat thereafter until FY2020E, the terminal year of our DCF model (see Exhibit 3).

Our DCF-based fair value for PLNG is ₹86

Calculation of equity value of PLNG using discounted cash flow analysis (₹ mn)

| | 2011E | 2012E | 2013E | 2014E | 2015E | 2016E | 2017E | 2018E | 2019E | 2020E | 2021E | 2022E |
|--|----------------|-----------------|------------------|---------------|---------------|---------------|---------------|-----------------------------|---------------|---------------|---------------|---------------|
| EBITDA | 9,893 | 12,858 | 15,432 | 18,465 | 20,275 | 21,344 | 22,407 | 22,314 | 22,216 | 22,104 | 22,104 | 22,104 |
| Adjusted tax expense | (1,706) | (2,721) | (2,674) | (2,900) | (3,249) | (3,449) | (5,020) | (6,008) | (6,399) | (6,683) | | |
| Change in working capital | (2,434) | (1,513) | (1,438) | (2,523) | (538) | (465) | 483 | 249 | (343) | (412) | | |
| Operating cash flow | 5,754 | 8,623 | 11,320 | 13,042 | 16,488 | 17,430 | 17,870 | 16,555 | 15,473 | 15,010 | | |
| Capital expenditure | (10,000) | (10,000) | (12,816) | (1,000) | (1,000) | (1,000) | (1,000) | (1,000) | (1,000) | (2,500) | | |
| Free cash flow | (4,246) | (1,377) | (1,496) | 12,042 | 15,488 | 16,430 | 16,870 | 15,555 | 14,473 | 12,510 | 12,510 | 12,510 |
| Discounted cash flow-now | (3,925) | (1,131) | (1,092) | 7,815 | 8,934 | 8,422 | 7,686 | 6,300 | 5,210 | 4,002 | | |
| Discounted cash flow-1 year forward | | (1,272) | (1,229) | 8,791 | 10,051 | 9,478 | 8,647 | 7,087 | 5,862 | 4,504 | 4,002 | |
| Discounted cash flow-2 year forward | | | (1,383) | 9,890 | 11,307 | 10,662 | 9,731 | 7,973 | 6,594 | 5,066 | 4,504 | 4,002 |
| | Now | + 1-year | + 2-years | | | | | | | | | |
| Discount rate (%) | 12.5% | 12.5% | 12.5% | | | | | | | | | |
| Total PV of free cash flow | 42,221 | 55,920 | 68,347 | | | | | | | | | |
| Terminal value assumption | | | | | | | | | | | | |
| Growth in perpetuity | 0.0% | 0.0% | 0.0% | | | | | | | | | |
| FCF in 2021E | 12,510 | 12,510 | 12,510 | | | | | | | | | |
| Exit FCF multiple (X) | 8.0 | 8.0 | 8.0 | | | | | | | | | |
| Exit EV/EBITDA multiple (X) | 4.5 | 4.5 | 4.5 | | | | | | | | | |
| Terminal value | 100,077 | 100,077 | 100,077 | | | | | | | | | |
| PV of terminal value | 32,015 | 32,015 | 32,015 | | | | | | | | | |
| Total company value | 74,236 | 87,934 | 100,362 | | | | | | | | | |
| Net debt | 16,207 | 23,757 | 29,931 | | | | | | | | | |
| Equity value | 58,029 | 64,177 | 70,431 | | | | | | | | | |
| Shares outstanding (mn) | 750 | 750 | 750 | | | | | | | | | |
| Estimated share price using DCF | 77 | 86 | 94 | | | | | | | | | |
| Estimated share price excluding Kochi | 62 | 67 | 72 | | | | | | | | | |
| Kochi project | 16 | 18 | 22 | | | | | | | | | |
| Sensitivity of 12-month fair value to WACC and perpetual growth | | | | | | | | | | | | |
| | | | | | | | | Perpetual growth (%) | | | | |
| | | | | | | | | -1.0% | -0.5% | 0.0% | 0.5% | 1.0% |
| WACC (%) | 11.5% | 92.4 | 94.8 | 97.4 | 100.3 | 103.4 | | | | | | |
| | 12.0% | 86.8 | 88.9 | 91.2 | 93.8 | 96.5 | | | | | | |
| | 12.5% | 81.6 | 83.5 | 85.6 | 87.8 | 90.3 | | | | | | |
| | 13.0% | 76.7 | 78.5 | 80.3 | 82.3 | 84.5 | | | | | | |
| | 13.5% | 72.3 | 73.8 | 75.5 | 77.3 | 79.2 | | | | | | |
| Fiscal Year end (March 31, XXXX) | | | | | | | | | | | | |
| Today | March-11 | March-12 | March-13 | March-14 | March-15 | March-16 | March-17 | March-18 | March-19 | March-20 | March-21 | March-22 |
| Days left | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 |
| Years left | 244 | 610 | 975 | 1,340 | 1,705 | 2,071 | 2,436 | 2,801 | 3,166 | 3,532 | 3,897 | 4,262 |
| Discount factor at WACC | 0.92 | 0.82 | 0.73 | 0.65 | 0.58 | 0.51 | 0.46 | 0.41 | 0.36 | 0.32 | 0.28 | 0.25 |

Source: Kotak Institutional Equities estimates

Petronet LNG: Profit model, balance sheet, cash model March fiscal year-ends, 2006-2014E (₹ mn)

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E | 2014E |
|--|---------------|---------------|---------------|---------------|----------------|----------------|----------------|----------------|---------------|
| Profit model (Rs mn) | | | | | | | | | |
| Net sales | 38,197 | 55,090 | 65,553 | 84,287 | 106,491 | 112,693 | 154,171 | 189,218 | 221,012 |
| EBITDA | 4,707 | 6,481 | 8,661 | 9,013 | 8,465 | 9,893 | 12,858 | 15,432 | 18,465 |
| Other income | 194 | 366 | 536 | 765 | 978 | 519 | 476 | 451 | 451 |
| Interest | (1,116) | (1,070) | (1,024) | (1,012) | (1,839) | (2,011) | (2,541) | (3,554) | (4,125) |
| Depreciation | (1,010) | (1,020) | (1,022) | (1,025) | (1,609) | (1,855) | (1,933) | (2,465) | (4,365) |
| Extraordinary items | 175 | — | — | — | — | — | — | — | — |
| Pretax profits | 2,950 | 4,756 | 7,152 | 7,740 | 5,995 | 6,547 | 8,860 | 9,864 | 10,426 |
| Tax | (256) | (6) | (2,185) | (2,526) | (1,410) | (1,305) | (2,115) | (1,966) | (2,078) |
| Deferred taxation | (745) | (1,617) | (220) | (30) | (540) | (870) | (828) | (1,311) | (1,385) |
| Net profits | 1,949 | 3,133 | 4,747 | 5,184 | 4,045 | 4,372 | 5,917 | 6,587 | 6,963 |
| Earnings per share (Rs) | 2.4 | 4.2 | 6.3 | 6.9 | 5.4 | 5.8 | 7.9 | 8.8 | 9.3 |
| Balance sheet (Rs mn) | | | | | | | | | |
| Total equity | 10,719 | 12,755 | 16,185 | 19,834 | 22,349 | 24,972 | 28,484 | 32,447 | 36,786 |
| Deferred taxation liability | 605 | 2,472 | 2,692 | 2,722 | 3,262 | 4,132 | 4,960 | 6,271 | 7,656 |
| Total borrowings | 12,599 | 13,832 | 15,776 | 22,817 | 24,998 | 31,998 | 37,498 | 44,498 | 37,998 |
| Current liabilities | 1,725 | 5,877 | 8,588 | 8,922 | 9,006 | 9,070 | 11,381 | 13,318 | 15,038 |
| Total liabilities and equity | 25,648 | 34,936 | 43,242 | 54,295 | 59,614 | 70,171 | 82,323 | 96,534 | 97,479 |
| Cash | 2,506 | 3,405 | 3,586 | 6,578 | 3,405 | 2,854 | 2,181 | 2,120 | 2,186 |
| Current assets | 2,946 | 7,478 | 7,890 | 11,519 | 8,811 | 11,309 | 15,134 | 18,508 | 22,751 |
| Total fixed assets | 18,627 | 21,273 | 26,293 | 33,156 | 42,012 | 50,622 | 59,623 | 70,520 | 67,155 |
| Investments | 1,569 | 2,780 | 5,473 | 3,043 | 5,386 | 5,386 | 5,386 | 5,386 | 5,386 |
| Total assets | 25,648 | 34,936 | 43,242 | 54,295 | 59,614 | 70,171 | 82,323 | 96,534 | 97,479 |
| Free cash flow (Rs mn) | | | | | | | | | |
| Operating cash flow, excl. working capital | 3,524 | 4,927 | 6,982 | 5,378 | 5,513 | 6,114 | 7,268 | 9,366 | 12,263 |
| Working capital | (2,057) | (710) | 1,589 | (3,384) | 3,026 | (2,434) | (1,513) | (1,438) | (2,523) |
| Capital expenditure | (335) | (36) | (263) | (27) | (15,757) | (10,000) | (10,000) | (12,816) | (1,000) |
| Investments | (1,390) | (1,211) | (2,780) | 2,462 | (2,339) | — | — | — | — |
| Free cash flow | (258) | 2,970 | 5,528 | 4,429 | (9,556) | (6,320) | (4,245) | (4,888) | 8,739 |
| Other income | 184 | 326 | (414) | 695 | 452 | 519 | 476 | 451 | 451 |
| Ratios (%) | | | | | | | | | |
| Debt/equity | 111 | 91 | 84 | 101 | 98 | 110 | 112 | 115 | 85 |
| Net debt/equity | 89 | 68 | 65 | 72 | 84 | 100 | 106 | 109 | 81 |
| RoAE | 19.5 | 23.6 | 27.8 | 25.0 | 16.8 | 16.0 | 18.9 | 18.3 | 16.7 |
| RoACE | 11.9 | 14.5 | 17.0 | 14.7 | 11.0 | 10.2 | 11.5 | 11.6 | 11.7 |
| Adjusted CROCI | 20.0 | 24.1 | 21.3 | 15.7 | 14.0 | 13.2 | 13.6 | 14.0 | 16.5 |
| Key assumptions | | | | | | | | | |
| Contract LNG volume (mn tons) | 4.8 | 5.1 | 4.8 | 4.8 | 7.1 | 7.5 | 7.5 | 8.0 | 10.0 |
| LNG purchase price (FOB) (US\$/mn BTU) | 2.5 | 3.3 | 3.7 | 4.2 | 4.7 | 4.9 | 5.5 | 5.9 | 5.7 |
| Base re-gasification charges (US\$/mn BTU) | 0.57 | 0.58 | 0.69 | 0.64 | 0.65 | 0.70 | 0.73 | 0.77 | 0.77 |
| Sales price (US\$/mn BTU) | 3.5 | 4.4 | 4.9 | 5.4 | 5.9 | 6.2 | 6.9 | 7.4 | 7.3 |
| Rupee/US dollar exchange rate | 44.3 | 45.3 | 40.1 | 45.8 | 47.4 | 46.0 | 46.0 | 46.0 | 46.0 |

Source: Company, Kotak Institutional Equities estimates

APPENDIX

GSPC dumps Petronet-LNG for Shell

Overcapacity at Petronet LNG's Dahej terminal has just lost it one of its biggest customers—frustrated GSPC has switched to using Shell's Hazira terminal for its short-term LNG cargoes. PETROWATCH learns GSPC was supposed to have brought in a short-term cargo from Stream (a 50:50 JV between Spanish, companies Repsol and Gas Natural) to the Dahej terminal. We now hear that it was forced to abort these plans at the very last minute and the ship turned back on the high seas. These rumors cannot be confirmed but on the morning of July 26 (Monday) GSPC landed a 53,000-tonne Stream cargo brought aboard LNG carrier Iberica Knutsen at Hazira, and announced it was switching loyalties from Petronet LNG to Shell.

"The (Stream) cargo should have come into Dahej in the last week of June," confirms a GSPC source, when contacted. "But GSPC was not allotted any window. All four Dahej LNG storage tanks are full to the brim." R-LNG has been accumulating for some time in the 10 mt/y Dahej terminal's storage tanks. "This is because many of Petronet-LNG's downstream customers have switched over to D6 gas," explains an observer. He adds that Petronet-LNG promoters Bharat Petroleum, Gail and Indian Oil are finding it especially hard to sell R-LNG to fertilizer and power companies, as these companies are allocated D6 gas on a priority basis "The situation is bad," we hear. "BPCL and IOC cannot sell even half of their 20 mcm/d share (of Dahej R-LNG)." But bad news for Petronet-LNG is good news for Shell, which has welcomed the GSPC move with open arms. Hazira had been experiencing a downturn, leading Shell to shut the terminal for 33 days between January and March this year. In April, Shell offered 1m t/y of the terminal's 3.6 m t/y capacity to GSPC, which now plans to bring in another six short-term cargoes from Stream to Hazira.

NOTE: GSPC had earlier brought two short-term Steam cargoes to Dahej: a 50,000-tonne cargo arrived aboard Catalunya Spirit on April 21 and a 55,000-tonne cargo arrived aboard Castillo de Villalba on May 22. All three cargoes so far have come in from Stream's Trinidad and Tobago liquefaction facilities. (Source: *Petrowatch*)

Government for RIL cutting gas output for Petronet sake; RIL says no

The government has asked Reliance Industries to cut gas output from its eastern offshore KG-D6 fields so that imported fuel stocks can be cleared, a demand that the Mukesh Ambani-run company has rejected.

Petroleum Ministry had in a meeting on April 30 asked Reliance to explore cutting down output so that the imported liquefied natural gas (LNG) accumulating at Petronet LNG Ltd's Dahej terminal in Gujarat can be sold to customers.

"Reliance may examine whether it would be possible to cutback the production from KG-D6 fields by some amount for a short period," according to the minutes of the meeting.

"Reliance has not agreed to or planned to cut down on the production of gas from KG basin," a company spokesperson said.

Petronet, which ships gas in its liquid form (LNG) from Qatar on a long-term contract, is facing a glut after three fertilizer plants that used LNG as feedstock shut down for maintenance and a power plant owned by NTPC tripped. Also, NTPC's Dadri plant is to undergo a shutdown from tomorrow. The schedule for outgo of gas from Petronet's Dahej import terminal in Gujarat was less than the inflow, creating a backlog of 75 million cubic meters or 96 per cent of inventory limit, according to the minutes.

The problem has been complicated by Petronet's decision to lease out Dahej terminal to Gujarat State Petroleum Corp (GSPC) for import of nine cargos or shipload of LNG even though state gas utility GAIL India did not have capacity in pipeline to evacuate any gas beyond the domestic production and already contracted long-term LNG.

While the Ministry did not ask Petronet to defer import of LNG - Petronet's contract with RasGas of Qatar has provisions to defer any cargo(s) and take their deliveries later during the year, it wanted domestic gas production to be cut to accommodate the expensive LNG.

By asking Reliance to cut output, the ministry had hoped it can push the imported gas to customers using KG-D6 gas. Industry observers expressed surprise at the decision saying imported expensive gas was being prioritized over cheaper domestic gas. "The priority should be to use cheaper fuel first and use expensive gas later," an official said.

Petronet's imports from Qatar cost US\$5.42 per million British thermal unit (ex-Dahej), while KG-D6 gas is priced at US\$4.20 per mmBtu. The April 30 meeting in the ministry also decided to set up "a coordination mechanism" between the domestic producers and Petronet so that commitment to buy overseas LNG is met. Power and fertilizer plants prefer using KG-D6 gas as feedstock, as besides being cheaper, they also get attractive commercial terms from Reliance. (Source: *Economic Times*, May 4, 2010)

JULY 29, 2010
RESULT

 Coverage view: **Attractive**

 Price (Rs): **352**

 Target price (Rs): **360**

 BSE-30: **17,992**

Asset quality disappoints again. Higher credit costs resulting from higher slippages (4.9%) impacted 1QFY11 earnings for Federal Bank (down 3% yoy, 24% below estimates). Gross NPLs increased sharply by 27% qoq. Slippages at 4-5% over the past few quarters continue to disappoint and raise questions about future trends. While valuations at 1XFY2012E PBR remain attractive, near-term upsides might be limited post recent outperformance (18% over last 3 months). Downgrade to ADD.

Company data and valuation summary

Federal Bank

Stock data

52-week range (Rs) (high,low) 369-211

Market Cap. (Rs bn) 60.2

Shareholding pattern (%)

Promoters 0.0

FIs 37.2

MFs 17.0

Price performance (%)

| | 1M | 3M | 12M |
|----------------|------|------|------|
| Absolute | 11.6 | 20.9 | 47.3 |
| Rel. to BSE-30 | 8.7 | 17.6 | 24.2 |

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|-------|-------|-------|
| EPS (Rs) | 27.2 | 36.4 | 49.0 |
| EPS growth (%) | (7.2) | 34.1 | 34.4 |
| P/E (X) | 13.0 | 9.7 | 7.2 |
| NII (Rs bn) | 14.1 | 16.8 | 19.7 |
| Net profits (Rs bn) | 4.6 | 6.2 | 8.4 |
| BVPS | 273.9 | 302.8 | 341.7 |
| P/B (X) | 1.3 | 1.2 | 1.0 |
| ROE (%) | 10.3 | 12.6 | 15.2 |
| Div. Yield (%) | 1.4 | 1.9 | 2.6 |

QUICK NUMBERS

- NII growth at 42%
NIM at 4.2%
- Slippages at 5% for the quarter
- Downgrade to ADD with TP of Rs 360

Post strong outperformance, we downgrade recommendation to ADD

The stock has seen a strong 18% outperformance over last 3 months, on the back of expected improvement in asset quality trends and a likely management change. Despite some delays, we believe that the change in management is likely to materialize over next 2-3 months. However, there has been no respite on the asset quality and fresh slippages at near 5% continue to remain high. This is likely to impact expected provisioning costs and we reduce our earnings estimates by 6% in FY2011E. Valuations at 1XFY2012E PBR are attractive and provide cushion despite weak operating performance. While we retain positive bias, we downgrade our rating one notch to ADD with the same TP rolling over to FY2012E financials.

Asset quality remains under pressure with fresh slippages at 5%; limited write-off in 1QFY11

Asset quality continues to remain under pressure with fresh slippages at Rs3.3 bn (4.9% annualized) for the quarter resulting in gross NPA increasing to Rs10.4 bn (3.7% of loans) compared to Rs6.3 bn in June 2009. In the past few quarters slippages have remained at 4% levels and we expect it to remain above industry averages for the next few quarters. Slippages for the quarter were mainly from retail and select corporate portfolio. The transitory nature of these slippages as well as the strong margins of 4% offers cushion on the higher credit costs required for these slippages. Provision coverage ratio continues to remain at one of the highest in the industry at 81%. Lower write-off during the quarter resulted in higher reported NPLs for the quarter.

Loan growth remains moderate; margins healthy at 4.2%

Federal Bank's loan book increased by a modest 17% yoy to Rs271 bn (flat qoq) during 1QFY11. Only large corporates saw a modest qoq growth of 5% with nearly all other segments declining qoq. Deposit growth was well below industry average at 10% yoy to Rs350 bn (3% decline qoq). CASA mobilisations were impressive at 22% yoy and 7.5% qoq resulting in improvement in CASA ratio to 29% from 26% in March 2010. CD ratio expanded further to 78% from 75% in March 2010. NIMs remained healthy at 4.2% for the quarter.

 M B Mahesh
 mb.mahesh@kotak.com
 Mumbai: +91-22-6634-1231

 Manish Karwa
 manish.karwa@kotak.com
 Mumbai: +91-22-6634-1350

 Kotak Institutional Equities Research
 kotak.research@kotak.com
 Mumbai: +91-22-6634-1100

Other operational highlights for the quarter

- ▶ Federal Bank's non-interest revenues declined by 25% yoy to Rs1.1 bn due to lower treasury profits (Rs166 mn-71% yoy decline). Fee income growth was muted at 5% yoy.
- ▶ Cost-income ratio for the quarter was maintained at 36% in June 2010. The bank has estimated an approximate pension liability of Rs1.3 bn (3% of FY2011 network) and is yet to be provided for.

We marginally change our near-term earnings estimates

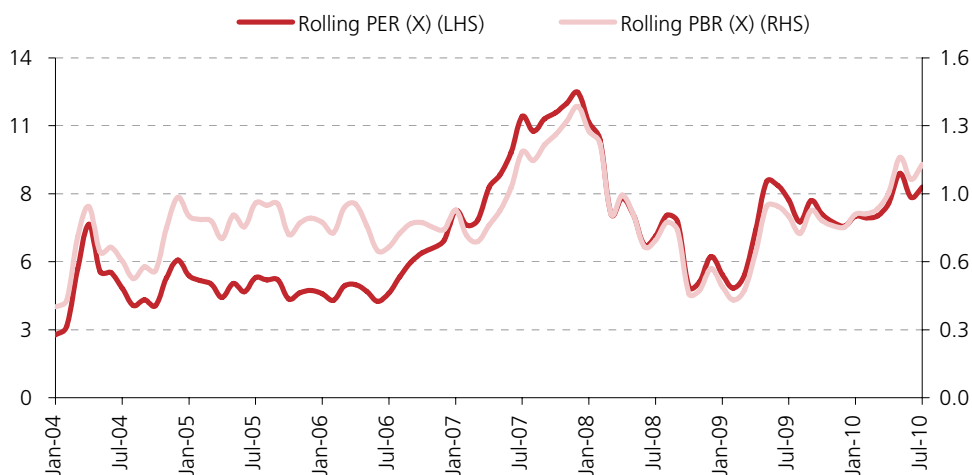
Old and new estimates

| | Old estimates | | New estimates | | % change | |
|-----------------------------|---------------|--------------|---------------|--------------|--------------|------------|
| | 2011E | 2012E | 2011E | 2012E | 2011E | 2012E |
| Net interest income | 16,403 | 19,411 | 16,833 | 19,694 | 2.6 | 1.5 |
| NIM (%) | 3.6 | 3.5 | 3.6 | 3.6 | | |
| Loan growth (%) | 20.1 | 21.0 | 20.1 | 21.0 | | |
| Loan loss provisions | 4,153 | 4,292 | 5,043 | 4,292 | 21.4 | — |
| Other income | 5,075 | 5,756 | 5,175 | 5,906 | 2.0 | 2.6 |
| Fee income | 1,176 | 1,317 | 1,176 | 1,317 | — | — |
| Treasury income | 250 | 250 | 350 | 400 | 40.0 | 60.0 |
| Operating expenses | 7,478 | 8,738 | 7,663 | 8,946 | 2.5 | 2.4 |
| Employee expenses | 4,078 | 4,583 | 4,263 | 4,791 | 4.5 | 4.5 |
| Depreciation on investments | — | — | — | — | | |
| Net profit | 6,613 | 8,216 | 6,231 | 8,373 | (5.8) | 1.9 |
| PBT-treasury+provisions | 13,750 | 16,179 | 13,994 | 16,253 | 1.8 | 0.5 |

Source: Kotak Institutional Equities, Company

Federal Bank: Rolling PER and PBR (X)

January 2004-July 2010



Source: Kotak Institutional Equities

Federal Bank quarterly results

March fiscal year-ends, 1QFY10-1QFY11 (Rs mn)

| | 1QFY10 | 2QFY10 | 3QFY10 | 4QFY10 | 1QFY11 | % chg | 1QFY11E | Actual Vs KS |
|--|--------------|--------------|--------------|--------------|--------------|---------------|--------------|-----------------|
| Interest earned | 8,744 | 9,011 | 9,446 | 9,531 | 9,518 | 8.9 | 9,719 | (2.1) |
| Interest/discount on advances/bills | 6,562 | 7,080 | 7,421 | 7,435 | 7,447 | 13.5 | 7,701 | (3.3) |
| Income on Investments | 2,048 | 1,855 | 1,984 | 1,947 | 2,041 | (0.4) | 1,999 | 2.1 |
| Interest on balances / inter bank | 131 | 71 | 42 | 59 | 21 | (83.9) | 15 | 44.3 |
| Others | 3 | 5 | — | 91 | | | | |
| Interest expended | 5,843 | 5,711 | 5,635 | 5,435 | 5,385 | (7.8) | 5,652 | (4.7) |
| Net interest income | 2,901 | 3,300 | 3,811 | 4,097 | 4,133 | 42.5 | 4,068 | 1.6 |
| Other Income | 1,474 | 1,364 | 1,165 | 1,306 | 1,099 | (25.5) | 1,179 | (6.8) |
| Sale of investments | 579 | 293 | 166 | 42 | 166 | (71.4) | 105 | 57.6 |
| Recovery of written off assets | 240 | 281 | 252 | 510 | 240 | | | |
| Other income excl treasury | 895 | 1,072 | 999 | 1,264 | 933 | 4.3 | 1,074 | (13.1) |
| Total income | 4,375 | 4,664 | 4,976 | 5,403 | 5,232 | 19.6 | 5,246 | (0.3) |
| Operating Expenses | 1,592 | 1,631 | 1,661 | 1,885 | 1,879 | 18.0 | 1,720 | 9.2 |
| Staff costs | 924 | 898 | 874 | 965 | 1,048 | 13.4 | 952 | 10.1 |
| Other operating expenses | 668 | 734 | 786 | 920 | 831 | 24.4 | 768 | 8.2 |
| Operating profit | 2,783 | 3,032 | 3,315 | 3,518 | 3,353 | 20.5 | 3,526 | (4.9) |
| Other Provisions and Contingencies | 520 | 1,501 | 1,053 | 979 | 1,334 | 156.7 | 1,042 | 28.0 |
| NPL | 932 | 1,588 | 839 | 773 | 1,358 | 45.7 | 966 | 40.6 |
| PBT | 2,263 | 1,531 | 2,262 | 2,539 | 2,020 | (10.8) | 2,484 | (18.7) |
| Provision for Taxes | 900 | 520 | 1,160 | 1,370 | 701 | (22.1) | 745 | (5.9) |
| Net Profit | 1,364 | 1,011 | 1,103 | 1,169 | 1,319 | (3.3) | 1,739 | (24.2) |
| Tax rate (%) | 40 | 34 | 51 | 54 | 35 | | | |
| PBT before provisions | 2,783 | 3,032 | 3,315 | 3,518 | 3,353 | 20.5 | 3,526 | (4.9) |
| Key balance sheet items (Rs bn) | | | | | | | | |
| Deposits | 317 | 334 | 346 | 361 | 350 | 10.2 | | |
| CASA ratio (%) | 26.1 | 25.8 | 25.9 | 26.2 | 29.0 | | | |
| Advances | 233 | 258 | 260 | 270 | 271 | 16.6 | | |
| Retail | 74 | 77 | 82 | 86 | 86 | | | |
| Retail to total advances (%) | 31.7 | 30.0 | 31.6 | 32.0 | 31.8 | | | |
| Investments | 117 | 118 | 126 | 131 | 120 | | | |
| Asset management details | | | | | | | | |
| Gross Non-performing assets (Rs mn) | 6,312 | 7,892 | 7,907 | 8,210 | 10,438 | 65.4 | | |
| Gross NPL ratio (%) | 2.7 | 3.0 | 3.0 | 3.0 | 3.7 | | | |
| Net Non-performing assets (Rs mn) | 673 | 1,379 | 1,469 | 1,288 | 2,007 | 198.1 | | |
| Net NPL ratio (%) | 0.3 | 0.5 | 0.6 | 0.5 | 0.7 | | | |
| Slippages | 2,170 | 1,830 | 2,430 | 3,220 | 3,270 | | | |
| Slippage ratio (%) | 3.9 | 3.1 | 3.8 | 4.9 | 4.9 | | | |
| Yield management measures (%) | | | | | | | | |
| Yield on advances | 11.42 | 11.57 | 11.40 | 10.98 | 10.81 | | | |
| Cost of deposits | 7.06 | 6.83 | 6.47 | 5.99 | 5.82 | | | |
| NIM | 3.31 | 3.70 | 4.05 | 4.19 | 4.15 | | | |
| Capital Adequacy details (%) | | | | | | | | |
| Capital Adequacy ratio | 19.9 | 18.5 | 18.5 | 18.4 | 17.9 | | | |
| Tier I | 17.2 | 17.0 | 17.1 | 16.9 | 16.6 | | | |

Source: Kotak Institutional Equities, Company

Federal Bank growth rates and key ratios

March fiscal year-ends, 2008-2013E (%)

| | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E |
|--|------------|------------|------------|------------|------------|------------|
| Growth rates (%) | | | | | | |
| Net loan | 26.9 | 18.4 | 20.4 | 20.1 | 21.0 | 20.8 |
| Customer assets | 26.2 | 19.8 | 19.4 | 19.5 | 20.5 | 20.4 |
| Investments excld. CPs and debentures | 30.4 | 5.9 | 12.0 | 17.8 | 21.8 | 21.3 |
| Net fixed and leased assets | 25.1 | 20.6 | 3.2 | (4.9) | 4.6 | (9.0) |
| Cash and bank balance | 18.7 | 25.2 | (20.8) | 15.3 | 16.5 | 16.9 |
| Total Asset | 29.6 | 19.5 | 12.4 | 17.1 | 19.1 | 19.1 |
| Deposits | 20.1 | 24.3 | 12.0 | 20.1 | 21.0 | 20.8 |
| Current | 20.4 | (1.5) | 26.9 | 23.7 | 21.0 | 20.8 |
| Savings | 19.1 | 28.0 | 18.1 | 20.1 | 19.5 | 19.3 |
| Fixed | 18.2 | 27.4 | 9.5 | 19.9 | 21.4 | 21.2 |
| Net interest income | 20.7 | 48.9 | 7.3 | 19.3 | 17.0 | 16.5 |
| Loan loss provisions | 75.1 | 65.3 | 16.6 | 22.1 | (14.9) | 20.8 |
| Total other income | 30.8 | 30.4 | 3.0 | (2.5) | 14.1 | 14.0 |
| Net fee income | 9.4 | 11.9 | 3.7 | 12.0 | 12.0 | 12.0 |
| Net capital gains | 52.3 | 10.6 | 30.1 | (67.6) | 14.3 | 12.5 |
| Net exchange gains | 11.0 | 51.0 | (11.8) | 15.0 | 15.0 | 15.0 |
| Operating expenses | 27.3 | 22.3 | 7.0 | 13.2 | 16.7 | 18.9 |
| Employee expenses | 22.6 | 19.5 | (4.1) | 16.5 | 12.4 | 13.4 |
| Key ratios (%) | | | | | | |
| Yield on average earning assets | 9.1 | 9.6 | 9.2 | 9.5 | 9.8 | 10.0 |
| Yield on average loans | 10.8 | 12.4 | 11.6 | 11.7 | 11.9 | 12.1 |
| Yield on average investments | 7.7 | 6.5 | 6.4 | 6.4 | 6.5 | 6.6 |
| Average cost of funds | 6.6 | 6.6 | 6.4 | 6.6 | 6.9 | 7.2 |
| Interest on deposits | 6.4 | 6.4 | 6.3 | 6.5 | 6.8 | 7.1 |
| Difference | 2.6 | 3.0 | 2.8 | 2.9 | 2.9 | 2.8 |
| Net interest income/earning assets | 3.2 | 3.8 | 3.5 | 3.6 | 3.6 | 3.5 |
| Spreads on lending business | 4.2 | 5.8 | 5.2 | 5.1 | 5.0 | 5.0 |
| Spreads on lending business (incl. Fees) | 4.8 | 6.3 | 5.6 | 5.5 | 5.4 | 5.3 |
| New provisions/average net loans | 1.3 | 1.7 | 1.7 | 1.7 | 1.2 | 1.2 |
| Total provisions/gross loans | 2.2 | 2.3 | 2.6 | 3.4 | 3.6 | 3.8 |
| Interest income/total income | 69.1 | 71.9 | 72.7 | 76.5 | 76.9 | 77.3 |
| Other income / total income | 30.9 | 28.1 | 27.3 | 23.5 | 23.1 | 22.7 |
| Fee income to total income | 7.1 | 5.5 | 5.4 | 5.3 | 5.1 | 5.0 |
| Fee income to advances | 0.5 | 0.5 | 0.4 | 0.4 | 0.4 | 0.3 |
| Fees income to PBT | 18.1 | 12.8 | 12.2 | 13.2 | 11.0 | 11.0 |
| Net trading income to PBT | 8.7 | 7.5 | 23.9 | 3.9 | 3.3 | 3.3 |
| Exchange income to PBT | 6.8 | 6.4 | 5.2 | 5.8 | 5.0 | 5.1 |
| Operating expenses/total income | 40.4 | 34.5 | 34.9 | 34.8 | 34.9 | 35.8 |
| Operating expenses/assets | 1.8 | 1.8 | 1.6 | 1.6 | 1.6 | 1.6 |
| Operating profit /AWF | 1.5 | 2.1 | 1.9 | 1.9 | 2.1 | 2.0 |
| Tax rate | 26.4 | 36.9 | 46.0 | 30.0 | 30.0 | 30.0 |
| Dividend payout ratio | 18.6 | 17.1 | 18.4 | 18.4 | 18.4 | 18.4 |
| Share of deposits | | | | | | |
| Current | 5.7 | 4.5 | 5.1 | 5.2 | 5.2 | 5.2 |
| Fixed | 73.6 | 75.5 | 73.8 | 73.7 | 73.9 | 74.2 |
| Savings | 19.4 | 20.0 | 21.1 | 21.1 | 20.9 | 20.6 |
| Loans-to-deposit ratio | 73.0 | 69.5 | 74.7 | 74.7 | 74.7 | 74.7 |
| Equity/assets (EoY) | 12.1 | 11.1 | 10.7 | 10.1 | 9.6 | 9.1 |
| Dupont analysis (%) | | | | | | |
| Net interest income | 3.1 | 3.7 | 3.4 | 3.6 | 3.5 | 3.4 |
| Loan loss provisions | 0.7 | 1.0 | 1.0 | 1.1 | 0.8 | 0.8 |
| Net other income | 1.4 | 1.4 | 1.3 | 1.1 | 1.1 | 1.0 |
| Operating expenses | 1.8 | 1.9 | 1.9 | 1.7 | 1.7 | 1.7 |
| Inv. depreciation | 0.1 | 0.1 | (0.2) | — | — | — |
| (1- tax rate) | 73.6 | 63.1 | 54.0 | 70.0 | 70.0 | 70.0 |
| ROA | 1.3 | 1.4 | 1.1 | 1.3 | 1.5 | 1.4 |
| Average assets/average equity | 10.6 | 8.6 | 9.2 | 9.6 | 10.2 | 10.7 |
| ROE | 13.6 | 12.1 | 10.3 | 12.6 | 15.2 | 15.1 |

Source: Kotak Institutional Equities, Company

Federal Bank income statement and balance sheet
 March fiscal year-ends, 2008-2013E (Rs mn)

| | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E |
|-----------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Income statement | | | | | | |
| Total interest income | 25,311 | 33,154 | 36,732 | 43,989 | 53,419 | 65,215 |
| Loans | 18,273 | 25,642 | 28,497 | 34,664 | 42,564 | 52,356 |
| Investments | 6,375 | 7,003 | 7,834 | 8,738 | 10,175 | 12,066 |
| Cash and deposits | 663 | 509 | 401 | 586 | 680 | 793 |
| Total interest expense | 16,474 | 19,999 | 22,624 | 27,156 | 33,725 | 42,276 |
| Deposits from customers | 15,259 | 18,732 | 21,588 | 25,757 | 32,474 | 41,025 |
| Net interest income | 8,837 | 13,155 | 14,108 | 16,833 | 19,694 | 22,939 |
| Loan loss provisions | 2,143 | 3,542 | 4,131 | 5,043 | 4,292 | 5,187 |
| Net interest income (after prov.) | 6,694 | 9,613 | 9,977 | 11,790 | 15,402 | 17,752 |
| Other income | 3,950 | 5,152 | 5,309 | 5,175 | 5,906 | 6,735 |
| Net fee income | 905 | 1,013 | 1,050 | 1,176 | 1,317 | 1,475 |
| Net capital gains | 750 | 830 | 1,080 | 350 | 400 | 450 |
| Net exchange gains | 338 | 510 | 450 | 518 | 595 | 684 |
| Operating expenses | 5,171 | 6,325 | 6,769 | 7,663 | 8,946 | 10,638 |
| Employee expenses | 3,194 | 3,817 | 3,661 | 4,263 | 4,791 | 5,432 |
| Depreciation on investments | 472 | 235 | (977) | — | — | — |
| Other Provisions | - | 280 | 899 | 400 | 400 | 400 |
| Pretax income | 5,002 | 7,930 | 8,596 | 8,902 | 11,961 | 13,449 |
| Tax provisions | 1,321 | 2,925 | 3,950 | 2,671 | 3,588 | 4,035 |
| Net Profit | 3,681 | 5,005 | 4,646 | 6,231 | 8,373 | 9,415 |
| % growth | 25.7 | 36.0 | (7.2) | 34.1 | 34.4 | 12.4 |
| PBT - Treasury + Provisions | 6,866 | 11,158 | 11,569 | 13,994 | 16,253 | 18,586 |
| % growth | 19.3 | 66.2 | 3.7 | 21.0 | 16.1 | 14.4 |
| Balance sheet | | | | | | |
| Cash and bank balance | 27,455 | 34,371 | 27,233 | 31,394 | 36,563 | 42,729 |
| Cash | 2,405 | 2,205 | 3,356 | 3,524 | 3,700 | 3,885 |
| Balance with RBI | 21,152 | 19,939 | 19,832 | 23,825 | 28,818 | 34,799 |
| Balance with banks | 2,168 | 5,961 | 2,532 | 2,532 | 2,532 | 2,532 |
| Net value of investments | 100,266 | 121,190 | 130,550 | 146,850 | 171,122 | 200,147 |
| Govt. and other securities | 77,988 | 82,948 | 93,268 | 110,359 | 135,080 | 164,508 |
| Shares | 2,330 | 1,538 | 1,538 | 1,538 | 1,538 | 1,538 |
| Debentures and bonds | 3,107 | 6,202 | 5,272 | 4,481 | 4,033 | 3,630 |
| Net loans and advances | 189,047 | 223,919 | 269,501 | 323,762 | 391,614 | 472,890 |
| Fixed assets | 2,328 | 2,808 | 2,898 | 2,755 | 2,882 | 2,624 |
| Other assets | 5,969 | 6,221 | 6,577 | 6,577 | 6,577 | 6,577 |
| Total assets | 325,064 | 388,509 | 436,756 | 511,337 | 608,759 | 724,967 |
| Deposits | 259,134 | 321,982 | 360,580 | 433,178 | 523,961 | 632,704 |
| Borrowings and bills payable | 13,226 | 12,509 | 15,468 | 12,509 | 12,509 | 12,509 |
| Other liabilities | 13,448 | 10,759 | 13,804 | 13,804 | 13,804 | 13,804 |
| Total liabilities | 285,808 | 345,250 | 389,852 | 459,492 | 550,274 | 659,018 |
| Paid-up capital | 1,710 | 1,710 | 1,710 | 1,710 | 1,710 | 1,710 |
| Reserves & surplus | 37,547 | 41,548 | 45,194 | 50,135 | 56,774 | 64,239 |
| Total shareholders' equity | 39,257 | 43,259 | 46,905 | 51,845 | 58,484 | 65,949 |

Source: Kotak Institutional Equities, Company

JULY 30, 2010
RESULT, CHANGE IN RECO.

 Coverage view: **Cautious**

 Price (Rs): **107**

 Target price (Rs): **83**

 BSE-30: **17,992**

How blue is my sky? We would advise investors to sell GSPL given the stock price is trading near the blue-sky scenario of no reduction in transmission tariffs. GSPL reported 1QFY11 net income at ₹1.05 bn (-2.6% qoq, +30.6% yoy) versus our estimate of ₹1.14 bn with gas transmission volumes at 36.3 mcm/d (versus 36.4 mcm/d in 4QFY10) and transmission tariffs at ₹0.77/cu m (versus ₹0.81/cu m in 4QFY10). We downgrade the stock to SELL with a target price of ₹83 given (1) stock trading 29% above our 12-month target price, (2) downside risks to volumes and (3) concerns about the sustainability of GSPL's transportation tariffs.

Company data and valuation summary

GSPL

| Stock data | | Forecasts/Valuations | | | |
|---------------------------------|-------------------------|----------------------|-------|-------|------|
| | | 2010 | 2011E | 2012E | |
| 52-week range (Rs) (high,low) | 108-62 | EPS (Rs) | 7.4 | 7.2 | 8.0 |
| Market Cap. (Rs bn) | 60.3 | EPS growth (%) | 234.7 | (2.6) | 12.1 |
| Shareholding pattern (%) | | P/E (X) | 14.6 | 14.9 | 13.3 |
| Promoters | 37.7 | Sales (Rs bn) | 10.0 | 10.7 | 12.2 |
| FIs | 12.4 | Net profits (Rs bn) | 4.1 | 4.0 | 4.5 |
| MFs | 9.8 | EBITDA (Rs bn) | 9.6 | 10.1 | 11.5 |
| Price performance (%) | | EV/EBITDA (X) | 7.4 | 7.3 | 6.1 |
| Absolute | 1M 5.6 3M 12.1 12M 56.1 | ROE (%) | 27.3 | 21.4 | 20.8 |
| Rel. to BSE-30 | 2.9 9.0 31.6 | Div. Yield (%) | 0.9 | 1.7 | 3.0 |

1QFY11 results highlights—lower-than-expected profits; sustainability of tariffs is an issue

GSPL reported 1QFY11 EBITDA at ₹2.41 bn (-2.1% qoq and +21.6% yoy) versus our estimate of ₹2.56 bn. The decline in EBITDA qoq despite stable gas transmission volumes qoq reflects moderately lower gas transmission charges at ₹0.77/cu m versus ₹0.81/cu m in 4QFY10. We have concerns on the sustainability of GSPL's current tariffs given that it will likely be lower once GSPL is brought under the purview of regulations for long-distance gas transportation pipelines. We find the current tariff too high since it translates into an estimated pre-tax ROCE of 23.6% based on 1QFY11 data versus 18.2% allowed as per new regulations effective November 2008.

Downgrade to SELL; stock near the best-case scenario

We have downgraded the stock to SELL from REDUCE with a revised target price of ₹83 (₹80 previously) given (1) lack of positive triggers for outperformance, (2) potential 22% downside to our 12-month target price and (3) concerns on sustainability of GSPL's transportation tariffs. We have been highlighting that the earnings and valuation of GSPL are a function of the assumption on tariffs. However, the current price is already discounting a scenario of no reduction in tariffs from current levels. Our fair valuation of the stock comes to ₹123 in a scenario of 1QFY11 tariffs of ₹0.77/cu m sustaining in perpetuity.

Slower ramp-up of KG D-6 gas and lower LNG imports to impact GSPL's volumes

We highlight the downside risk to GSPL's transmission volumes given (1) slower-than-expected ramp-up in gas production from RIL's KG D-6 block and (2) lower imported LNG volumes due to drying up of spot cargoes. We expect RIL to produce 64 mcm/d of gas in FY2011E and 72 mcm/d in FY2012E versus initial guidance of ramping up to peak production of 80 mcm/d by April 2010. We model gas transmission volumes for FY2011E, FY2012E and FY2013E at 38.8 mcm/d, 47.1 mcm/d and 53.6 mcm/d, respectively versus 32 mcm/d in FY2010.

Cut FY2011E and FY2012E EPS by 20% and 11%

We have revised FY2011E, FY2012E and FY2013E EPS to ₹7.2, ₹8 and ₹9 from ₹8.9, ₹9.1 and ₹9.2 to reflect (1) lower gas transmission volumes, (2) higher transmission tariffs and (3) 1QFY11 results.

QUICK NUMBERS

- **1QFY11 tariff translates into an estimated pre-tax ROCE of 23.6%**
- **22% downside to our target price from current levels**
- **Fair value drops to ₹60 assuming average CROCI of 14% in FY2011-21E**

Gundeep Singh
gundeep.singh@kotak.com
Mumbai: +91-22-6634-1286

Sanjeev Prasad
sanjeev.prasad@kotak.com
Mumbai: +91-22-6634-1229

Tarun Lakhotia
tarun.lakhotia@kotak.com
Mumbai: +91-22-6634-1188

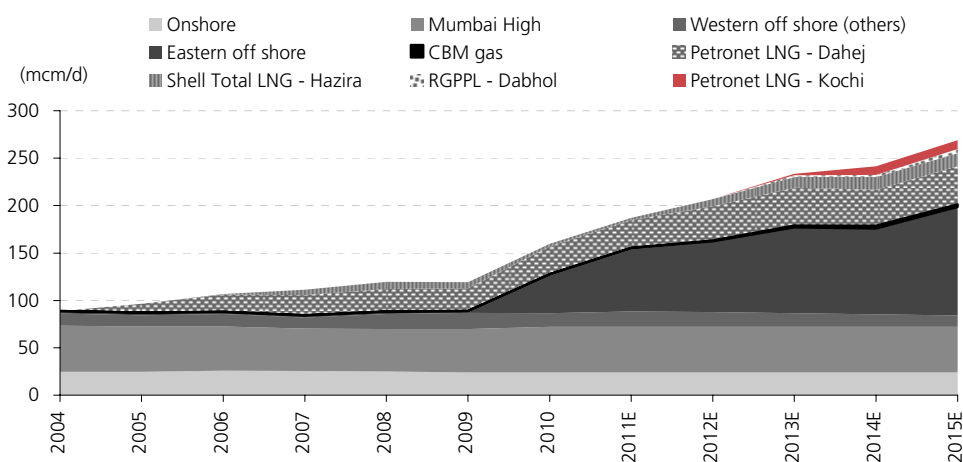
Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Downside risk to transmission volumes as supply slips

We see downside risk to GSPL's gas transmission volumes given slippages in domestic gas supply. Exhibit 1 shows our estimate of gas supply in India. We expect gas supply to increase to 241 mcm/d in FY2013E from 160 mcm/d in FY2010 led by (1) higher LNG imports and (2) ramp-up in gas production from RIL's KG D-6 block. We highlight that there have been slippages in several projects—(1) slower-than-expected ramp-up from RIL's KG D-6 block, (2) RIL's NEC-25 block, (3) ONGC's KG-DWN-98/2 and (4) GSPC's Deen Dayal block. In addition, we see lower offtake from imported LNG versus earlier expectations. We estimate GSPL's volumes to ramp up to 53.6 mcm/d by FY2013E versus 32 mcm/d in FY2010 and ~36 mcm/d currently.

We see delays in several domestic projects

Supply of natural gas in India, March fiscal year-ends, 2004-15E (mcm/d)



Note:

(a) Eastern offshore includes gas from Reliance Industries' KG D-6 block.

Source: Kotak Institutional Equities estimates

Fair valuation can range from ₹60—₹123 depending on tariff assumption

We highlight that GSPL's current tariffs reflects its monopoly status as can be seen from its pre-tax ROCE of 28.7% in FY2009. We note that its returns will increase further as volumes increase over the next few years without a commensurate increase in capex. Our 12-month DCF-based target price of ₹83 is based on tariff assumptions, which result in very high CROCI of 17% in FY2011-21E. If we assume 1QFY11 tariff of ₹0.77/cu m in perpetuity, we get a 12-month forward DCF valuation of ₹123 and average CROCI of 21.7% in FY2011-21E. However, the same drops to ₹60 with average CROCI of 14% in FY2011-21E based on a constant tariff of ₹0.5/cu m in perpetuity. We believe the last scenario may be more reflective of reality. The new regulations for gas transmission companies permit 12% post-tax or 18.18% pre-tax return on capital employed.

GSPL's valuation is highly sensitive to tariff assumptions
DCF valuation, CROCI and ROCE at various levels of average tariff, 2011E-21E

| Average tariff (Rs/cu m) | Valuation (Rs/share) | CROCI (%) | ROCE (%) | Comments |
|-----------------------------|-------------------------|--------------|-------------|-------------------------------------|
| 0.77 | 123 | 21.7 | 48.7 | 1QFY11 tariffs in perpetuity |
| 0.70 | 106 | 19.7 | 42.7 | |
| 0.61 | 83 | 17.0 | 33.0 | Base case |
| 0.55 | 73 | 15.6 | 29.9 | |
| 0.50 | 60 | 14.0 | 25.0 | Likely regulated CROCI |

Source: Kotak Institutional Equities estimates

Details of 1QFY11 results—higher gas volumes boosted profits

Exhibit 3 gives the details of 1QFY11 results. We discuss key financial and operating highlights.

Interim results of GSPL, March fiscal year-ends (₹ mn)

| | 1QFY11 | 1QFY11E | 1QFY10 | 4QFY10 | (% chg) | | | 2011E |
|-----------------------------------|--------------|--------------|--------------|--------------|---------------|-------------|--------------|---------------|
| | | | | | 1QFY11E | 1QFY10 | 4QFY10 | |
| Net sales | 2,545 | 2,730 | 2,108 | 2,668 | (6.8) | 20.7 | (4.6) | 10,666 |
| Total expenditure | (137) | (167) | (128) | (208) | (17.9) | 6.7 | (34.4) | (805) |
| Inc/(Dec) in stock | — | — | — | — | | | | — |
| Operating costs | — | — | — | — | | | | (343) |
| Gas transportation charges | — | — | (4) | — | | | | — |
| Connectivity charges | — | — | — | — | | | | — |
| Staff cost | (26) | (30) | (28) | (47) | | | | (147) |
| Other expenditure | (111) | (137) | (97) | (162) | (18.7) | 14.7 | (31.3) | (314) |
| EBITDA | 2,408 | 2,564 | 1,980 | 2,460 | (6.0) | 21.6 | (2.1) | 9,861 |
| OPM (%) | 94.6 | 93.9 | 93.9 | 92.2 | | | | 92.5 |
| Other income | 30 | 35 | 35 | 32 | (14.8) | (14.8) | (6.0) | 284 |
| Interest | (224) | (240) | (245) | (225) | (6.5) | (8.5) | (0.3) | (1,148) |
| Depreciation | (687) | (650) | (550) | (632) | 5.7 | 24.9 | 8.7 | (2,961) |
| Pretax profits | 1,527 | 1,709 | 1,220 | 1,634 | (10.6) | 25.1 | (6.6) | 6,036 |
| Contribution towards GSEDS | — | — | — | — | | | | — |
| Tax | (476) | (568) | (381) | (384) | | | | (1,342) |
| Deferred taxation | (0) | — | (34) | (172) | | | | (663) |
| Net income | 1,051 | 1,141 | 805 | 1,079 | (7.9) | 30.6 | (2.6) | 4,031 |
| Adjusted profits | 1,051 | 1,141 | 805 | 1,079 | (7.9) | 30.6 | (2.6) | 4,031 |
| Income tax rate (%) | 31.2 | 33.2 | 34.0 | 34.0 | | | | 33.2 |
| Pipeline volumes | | | | | | | | |
| Pipeline volumes (mcm) | 3,304 | 3,413 | 2,304 | 3,278 | (3.2) | 43.4 | 0.8 | 14,162 |
| Pipeline volumes (mcm/d) | 36.3 | 37.5 | 25.3 | 36.4 | (3.2) | 43.4 | (0.3) | 38.8 |
| Gas transmission charge (Rs/cu m) | 0.77 | 0.80 | 0.91 | 0.81 | (3.7) | (15.8) | (5.3) | 0.75 |

Source: Company, Kotak Institutional Equities estimates

- ▶ **Financial highlights.** GSPL reported 1QFY11 EBITDA at ₹2.41 bn versus ₹1.98 bn in 1QFY10 and ₹2.46 bn in 4QFY10. 1QFY11 net income was at ₹1.05 bn (-2.6% qoq, +30.6% yoy). The sharp yoy jump in profits was led by higher transmission volumes which, in turn, were driven by start of gas from RIL's KG D-6 block. GSPL is currently transmitting ~23 mcm/d of gas from RIL's KG D-6 block.
- ▶ **Operating details.** GSPL's 1QFY11 gas transmission volumes were stable at 36.3 mcm/d versus 36.4 mcm/d in 4QFY10; our estimate was 37.5 mcm/d for 1QFY11. GSPL's 1QFY11 gas transmission tariff was ₹0.77/cu m compared to ₹0.91/cu m in 1QFY10 and ₹0.81/cu m in 4QFY10.

Earnings assumptions

Exhibit 4 gives our DCF valuation.

DCF valuation of GSPL (₹ mn)

| | 2011E | 2012E | 2013E | 2014E | 2015E | 2016E | 2017E | 2018E | 2019E | 2020E | 2021E | 2022E | 2023E |
|---|---------------|-----------------|------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| EBITDA | 9,861 | 11,259 | 11,650 | 11,549 | 11,388 | 11,970 | 11,945 | 11,919 | 11,891 | 11,861 | 11,829 | 11,829 | 11,829 |
| Adjusted tax expense | (1,598) | (2,641) | (2,959) | (3,064) | (3,133) | (3,461) | (3,586) | (3,697) | (3,794) | (3,880) | (4,491) | | |
| Change in working capital | (5,009) | (2,207) | (25) | 3 | 7 | (35) | — | — | — | — | — | | |
| Operating cash flow | 3,255 | 6,410 | 8,665 | 8,488 | 8,262 | 8,474 | 8,359 | 8,222 | 8,097 | 7,981 | 7,338 | | |
| Capital expenditure | (4,076) | (250) | (250) | (250) | (250) | (250) | (250) | (250) | (250) | (250) | (1,761) | | |
| Free cash flow | (821) | 6,160 | 8,415 | 8,238 | 8,012 | 8,224 | 8,109 | 7,972 | 7,847 | 7,731 | 5,578 | 5,578 | 5,578 |
| Discounted cash flow | (761) | 5,097 | 6,217 | 5,434 | 4,719 | 4,323 | 3,806 | 3,341 | 2,936 | 2,582 | 1,663 | | |
| Discounted cash flow-1 year forward | | 5,711 | 6,963 | 6,086 | 5,285 | 4,844 | 4,263 | 3,742 | 3,289 | 2,893 | 1,863 | 1,663 | |
| Discounted cash flow-2 year forward | | | 7,801 | 6,816 | 5,919 | 5,425 | 4,776 | 4,191 | 3,683 | 3,240 | 2,087 | 1,863 | 1,663 |
| | Now | + 1-year | + 2-years | | | | | | | | | | |
| Discount rate (%) | 12.0 | 12.0 | 12.0 | | | | | | | | | | |
| Total PV of free cash flow | 39,358 | 46,601 | 47,465 | | | | | | | | | | |
| Terminal value assumption | | | | | | | | | | | | | |
| Growth to perpetuity (%) | — | — | — | | | | | | | | | | |
| FCF in 2021E | 5,578 | 5,578 | 5,578 | | | | | | | | | | |
| Exit FCF multiple (X) | 8.3 | 8.3 | 8.3 | | | | | | | | | | |
| Exit EV/EBITDA multiple (X) | 3.9 | 3.9 | 3.9 | | | | | | | | | | |
| Terminal value | 46,480 | 46,480 | 46,480 | | | | | | | | | | |
| PV of terminal value | 13,861 | 13,861 | 13,861 | | | | | | | | | | |
| Total company value | 53,219 | 60,461 | 61,325 | | | | | | | | | | |
| Net debt | 10,856 | 13,609 | 10,114 | | | | | | | | | | |
| Equity value | 42,363 | 46,853 | 51,211 | | | | | | | | | | |
| Shares outstanding (mn) | 562 | 562 | 562 | | | | | | | | | | |
| Estimated share price using DCF | 75 | 83 | 91 | | | | | | | | | | |
| Fiscal Year end (March 31, XXXX) | March-11 | March-12 | March-13 | March-14 | March-15 | March-16 | March-17 | March-18 | March-19 | March-20 | March-21 | March-22 | March-23 |
| Today | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 |
| Days left | 244 | 610 | 975 | 1,340 | 1,705 | 2,071 | 2,436 | 2,801 | 3,166 | 3,532 | 3,897 | 4,262 | 4,627 |
| Years left | 0.67 | 1.67 | 2.67 | 3.67 | 4.67 | 5.67 | 6.67 | 7.67 | 8.67 | 9.68 | 10.68 | 11.68 | 12.68 |
| Discount factor at WACC | 0.93 | 0.83 | 0.74 | 0.66 | 0.59 | 0.53 | 0.47 | 0.42 | 0.37 | 0.33 | 0.30 | 0.27 | 0.24 |

Source: Kotak Institutional Equities estimates

- ▶ **Gas transportation volumes.** We model FY2011E, FY2012E and FY2013E gas transportation volumes to increase to 38.8 mcm/d, 47.1 mcm/d and 53.6 mcm/d from 32 mcm/d in FY2010.
- ▶ **Gas transportation charges.** We model FY2011E, FY2012E and FY2013E gas transportation tariffs at ₹0.75/cu m, ₹0.71/cu m and ₹0.65/cu m. We note that our assumptions result in a healthy 18.2%, 18% and 18.1% CROCI in FY2011E, FY2012E and FY2013E.

GSPL: Profit model, balance sheet, cash model, March fiscal year-ends, 2007-14E (₹ mn)

| | 2007 | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E | 2014E |
|--|----------------|---------------|----------------|---------------|----------------|---------------|---------------|---------------|
| Profit model (Rs mn) | | | | | | | | |
| Net sales | 3,176 | 4,179 | 4,875 | 10,009 | 10,666 | 12,155 | 12,623 | 12,578 |
| EBITDA | 2,677 | 3,645 | 4,249 | 9,414 | 9,861 | 11,259 | 11,650 | 11,549 |
| Other income | 175 | 294 | 243 | 159 | 284 | 263 | 263 | 262 |
| Interest | (457) | (815) | (870) | (938) | (1,148) | (1,227) | (814) | (349) |
| Depreciation | (1,026) | (1,632) | (1,705) | (2,365) | (2,961) | (3,531) | (3,519) | (3,511) |
| Pretax profits | 1,369 | 1,491 | 1,918 | 6,269 | 6,036 | 6,764 | 7,580 | 7,952 |
| Contribution towards GSEDS | — | — | — | — | — | — | — | — |
| Tax | (70) | (389) | (536) | (1,870) | (1,342) | (2,236) | (2,672) | (2,936) |
| Deferred taxation | (409) | (82) | (145) | (261) | (663) | (11) | 154 | 294 |
| Net profits | 894 | 999 | 1,234 | 4,138 | 4,031 | 4,517 | 5,062 | 5,310 |
| Earnings per share (Rs) | 1.6 | 1.8 | 2.2 | 7.4 | 7.2 | 8.0 | 9.0 | 9.4 |
| | | | | 7.4 | 8.9 | 9.1 | 9.2 | 9.5 |
| Balance sheet (Rs mn) | | | | | | | | |
| Total equity | 9,659 | 11,410 | 12,152 | 15,637 | 18,489 | 20,899 | 23,010 | 24,605 |
| Deferred tax liability | 917 | 999 | 1,144 | 1,405 | 2,068 | 2,079 | 1,925 | 1,631 |
| Total borrowings | 8,638 | 9,660 | 11,509 | 12,595 | 14,665 | 11,165 | 5,965 | 1,365 |
| Current liabilities | 1,845 | 5,106 | 5,331 | 8,334 | 3,165 | 1,041 | 1,041 | 1,042 |
| Total liabilities and equity | 21,059 | 27,175 | 30,137 | 37,972 | 38,387 | 35,184 | 31,941 | 28,642 |
| Cash | 1,811 | 2,569 | 975 | 1,740 | 1,057 | 1,052 | 1,051 | 1,016 |
| Current assets | 2,126 | 2,928 | 4,641 | 5,808 | 5,647 | 5,730 | 5,756 | 5,754 |
| Total fixed assets | 17,029 | 21,259 | 24,132 | 29,755 | 31,014 | 27,733 | 24,465 | 21,204 |
| Investments | — | 356 | 356 | 666 | 666 | 666 | 666 | 666 |
| Deferred expenditure | 93 | 63 | 33 | 3 | 3 | 3 | 3 | 3 |
| Total assets | 21,059 | 27,175 | 30,137 | 37,972 | 38,387 | 35,184 | 31,941 | 28,642 |
| Free cash flow (Rs mn) | | | | | | | | |
| Operating cash flow, excl. working capital | 2,212 | 2,743 | 2,918 | 6,435 | 7,227 | 7,796 | 8,163 | 8,265 |
| Working capital changes | (1,058) | 2,460 | (1,752) | 1,836 | (5,009) | (2,207) | (25) | 3 |
| Capital expenditure | (4,404) | (5,863) | (4,579) | (7,787) | (4,076) | (250) | (250) | (250) |
| Investments | — | (356) | — | (310) | — | — | — | — |
| Other income | 146 | — | 297 | 159 | 284 | 263 | 263 | 262 |
| Free cash flow | (3,103) | (659) | (3,116) | 642 | (1,574) | 5,602 | 8,151 | 8,280 |
| Ratios (%) | | | | | | | | |
| Debt/equity | 81.7 | 77.9 | 86.6 | 73.9 | 71.3 | 48.6 | 23.9 | 5.2 |
| Net debt/equity | 45.0 | 43.8 | 46.4 | 42.5 | 41.6 | 32.7 | 19.3 | 4.9 |
| RoAE | 8.8 | 8.8 | 9.6 | 27.3 | 21.4 | 20.8 | 21.1 | 20.8 |
| RoACE | 10.0 | 8.2 | 8.6 | 18.6 | 17.2 | 15.4 | 16.7 | 17.9 |
| CROCI | 13.5 | 16.9 | 14.8 | 23.6 | 18.2 | 18.0 | 18.1 | 17.6 |
| Key assumptions | | | | | | | | |
| Volumes-old pipelines (mcm/d) | 12.6 | 12.7 | 11.1 | 13.8 | 14.0 | 15.0 | 17.0 | 20.0 |
| Volumes-new pipelines (mcm/d) | 1.7 | 4.1 | 3.8 | 18.2 | 24.8 | 32.1 | 36.6 | 37.6 |
| Volumes (mcm/d) | 14.3 | 16.8 | 14.9 | 32.0 | 38.8 | 47.1 | 53.6 | 57.6 |
| Average tariff (Rs/cu m) | 0.61 | 0.67 | 0.83 | 0.86 | 0.75 | 0.71 | 0.65 | 0.60 |

Source: Company, Kotak Institutional Equities estimates

JULY 30, 2010

RESULT

Coverage view: **Cautious**

Price (Rs): **878**

Target price (Rs): **935**

BSE-30: **17,992**

1QFY11 results marred by one-off items. Aban reported 1QFY11 net income (consolidated) at ₹1.4 bn versus our estimate of ₹2.9 bn. The weaker-than-expected performance was due to provision of ₹3.4 bn on account of (1) loss of Aban Pearl (adjusted for insurance claim received) and (2) ₹137 mn for diminution in the value of investments. 1QFY11 reported EBITDA of ₹5.2 bn (+10.9% yoy and -21.1% qoq) was below our estimate of ₹5.9 bn. We maintain our ADD rating given potential upside of 6.5% to our revised DCF-based target price of ₹935. Key downside risks stem from debt-repayment capability.

Company data and valuation summary

Aban Offshore

| Stock data | | Forecasts/Valuations | | | |
|---------------------------------|-------------------|----------------------|-------|-------|-------|
| | | 2010 | 2011E | 2012E | |
| 52-week range (Rs) (high,low) | 1,682-636 | EPS (Rs) | 94.5 | 154.1 | 139.3 |
| Market Cap. (Rs bn) | 38.2 | EPS growth (%) | (2.5) | 63.0 | (9.6) |
| Shareholding pattern (%) | | P/E (X) | 9.3 | 5.7 | 6.3 |
| Promoters | 52.9 | Sales (Rs bn) | 33.6 | 37.4 | 37.9 |
| FIs | 9.6 | Net profits (Rs bn) | 4.1 | 7.0 | 6.2 |
| MFs | 11.8 | EBITDA (Rs bn) | 21.0 | 22.4 | 21.7 |
| Price performance (%) | | EV/EBITDA (X) | 8.5 | 6.8 | 6.6 |
| Absolute | 1M 3M 12M | ROE (%) | 21.7 | 33.1 | 22.9 |
| Rel. to BSE-30 | 6.9 (25.7) (13.6) | Div. Yield (%) | 0.4 | 0.4 | 0.5 |
| | 4.2 (27.7) (27.1) | | | | |

1QFY11 EBITDA lower than our estimate

Aban reported 1QFY11 EBITDA (consolidated) at ₹5.2 bn which was below our estimate of ₹5.9 bn. The weaker-than-expected performance was led by (1) lower usage days and (2) higher employee cost due to annual bonus payouts. Aban reported 1QFY11 net loss (consolidated) of ₹1.4 bn versus our estimate net income of ₹2.9 bn. The results were impacted due to provision of ₹3.4 bn on account of (1) ₹3.3 bn loss of Aban Pearl (adjusted for insurance claim received) and (2) ₹137 mn for diminution in the value of investments.

Receipt of insurance claim allays a key concern

We highlight that Aban has received 97% of the claim amount of US\$235 mn and the balance amount is expected to be received shortly. This should allay a key investor concern regarding (1) the acceptability of the claim and (2) the amount of claim. In addition, the receipt of cash should give some breathing space for debt repayment in the near future; although the loss of revenues from Aban Pearl has put the company's debt repayment capacity in a tighter spot. We highlight that Aban's net debt/EBITDA ratio stands at 5.2X and 4.9X in FY2011E and FY2012E and EBITDA to interest coverage ratio is at 2.6X and 2.8X in FY2011E and FY2012E.

Valuations are reasonable

We maintain our ADD rating on the stock with a revised DCF-based target price of ₹935 (₹900 previously). We have retained our ADD rating given (1) inexpensive valuations and (2) potential upside of 6.5% to our target price. We note that the stock valuations look reasonable with the stock currently trading at 6.8X FY2011E EBITDA and 6.6X FY2012E EBITDA. On a P/E basis, the stock is trading at 5.7X FY2011E EPS and 6.3X FY2012E EPS.

QUICK NUMBERS

- One-off of ₹3.4 bn in 1QFY11 reported net loss of ₹1.4 bn
- EBITDA to interest coverage ratio at 2.6X and 2.8X in FY2011E and FY2012E
- Net debt/EBITDA ratio stands at 5.2X and 4.9X in FY2011E and FY2012E

Gundeep Singh
gundeep.singh@kotak.com
Mumbai: +91-22-6634-1286

Tarun Lakhota
tarun.lakhota@kotak.com
Mumbai: +91-22-6634-1188

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Deployment of idle rigs gives some breathing space

We note that Aban's entire fleet except Aban Abraham and Deep Venture is either deployed or has been contracted. This should allay concerns with respect to idle fleet. Exhibit 1 gives details of the existing and new contracts along with the contract amounts and tenure. The deployment of most of the fleet should provide some comfort to our earnings estimates for FY2011E and FY2012E. We note that we are building a sharp decline in dayrates (upto 25%) for jack up rigs to reflect the demand-supply imbalance in the jack-up rig market.

Aban Offshore, Contract details Contract period and day rates

| Name | Location | Contract period | | Day rates | | Status |
|--------------------------------------|--------------|-----------------|-----------|-----------|-----------|-------------|
| | | Start date | End date | Currency | Amount | |
| Fleet- Aban Offshore Ltd | | | | | | |
| Aban-II | East coast | 26-May-07 | 25-Sep-10 | INR | 3,782,466 | Operational |
| Aban-III | Mumbai High | 1-Mar-08 | 30-Apr-11 | USD | 156,600 | Operational |
| Aban-IV | Mumbai High | 30-Dec-07 | 31-Jan-11 | USD | 156,600 | Operational |
| Aban-V | Mumbai High | 1-Mar-08 | 31-May-11 | USD | 156,600 | Operational |
| Aban-VI | Persian Gulf | 1-Jan-08 | 31-Dec-13 | EUR | 62,450 | Operational |
| FPU Tahara | East coast | 1-Jan-10 | 31-Jan-11 | USD | 49,000 | Operational |
| Aban Ice | Mumbai High | 1-Jul-09 | 30-Sep-12 | INR | 6,185,700 | Operational |
| Fleet- Aban Singapore Pte Ltd | | | | | | |
| Aban-VII | Qatar | 1-Apr-10 | 31-Dec-10 | USD | 59,524 | Operational |
| Aban-VIII | Middle East | 1-Jun-08 | 30-Jun-12 | USD | 170,000 | Operational |
| Aban Abraham | | | | | | Marketing |
| Fleet- Sinvest | | | | | | |
| Deep Driller 1 | India | 15-Jul-10 | 14-Jul-11 | USD | 117,143 | Operational |
| Deep Driller 2 | Middle East | 1-Nov-09 | 31-Oct-12 | USD | 176,667 | Operational |
| Deep Driller 3 | Malaysia | 15-Oct-08 | 30-Oct-12 | USD | 165,000 | Operational |
| Deep Driller 4 | Middle East | 1-Nov-09 | 31-Oct-12 | USD | 176,667 | Operational |
| Deep Driller 5 | Middle East | 1-Sep-09 | 30-Sep-12 | USD | 176,667 | Operational |
| Deep Driller 6 | Middle East | 21-May-10 | 20-May-14 | USD | 133,571 | Operational |
| Deep Driller 7 | Mexico | 1-Nov-09 | 31-Dec-11 | USD | 106,000 | Operational |
| Deep Driller 8 | Brunei | 1-Sep-10 | 31-Aug-14 | USD | 113,571 | Operational |
| Deep Venture | | | | | | Marketing |

Source: Company, Kotak Institutional Equities estimates

Key details of 1QFY11 results

Exhibit 2 gives details of Aban's 1QFY11 results and compares it with 4QFY10 and 1QFY10 results.

Interim results of Aban Offshore (consolidated), March fiscal year-ends (₹ mn)

| | 1QFY11 | 1QFY11E | 1QFY10 | 4QFY10 | (% chg.) | | |
|----------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|------------------|
| | | | | | 1QFY11E | 1QFY10 | 4QFY10 |
| Net sales | 8,425 | 9,372 | 7,935 | 10,210 | (10.1) | 6.2 | (17.5) |
| Total expenditure | (3,223) | (3,443) | (3,246) | (3,618) | (6.4) | (0.7) | (10.9) |
| Consumption of stores and spares | (333) | — | (382) | (265) | | | |
| Staff cost | (884) | — | (736) | (866) | | | |
| Machinery rental | (129) | — | (162) | (263) | | | |
| Repairs to machinery | (102) | — | (138) | (315) | | | |
| Insurance | (126) | — | (141) | (172) | | | |
| Other expenses | (1,648) | — | (1,686) | (1,737) | | | |
| EBITDA | 5,202 | 5,930 | 4,689 | 6,592 | (12.3) | 10.9 | (21.1) |
| OPM (%) | 61.7 | 63.3 | 59.1 | 64.6 | | | |
| Other income | 143 | 75 | 99 | 10 | 90.4 | 43.8 | 1,294.1 |
| Interest | (2,272) | (2,100) | (2,364) | (2,194) | 8.2 | (3.9) | 3.5 |
| Depreciation | (1,291) | (1,200) | (989) | (1,281) | 7.6 | 30.5 | 0.8 |
| Pretax profits | 1,783 | 2,705 | 1,435 | 3,127 | (34.1) | 24.2 | (43.0) |
| Extraordinaries | (3,496) | — | — | (2,408) | | | |
| Reported PBT | (1,713) | 2,705 | 1,435 | 719 | (163.3) | (219.4) | (338.2) |
| Tax | (712) | (916) | (627) | (563) | | | |
| Deferred taxation | 35 | — | 19 | 22 | | | |
| Net income | (2,391) | 1,788 | 827 | 178 | (233.7) | (389.1) | (1,443.3) |
| Share in joint venture | 952 | 1,078 | 282 | 215 | (11.7) | 238.1 | 343.4 |
| Minority interest | — | — | — | — | | | |
| Reported PAT | (1,439) | 2,866 | 1,109 | 393 | (150.2) | (229.8) | (466.5) |
| Adjusted PAT | 2,057 | 2,866 | 1,109 | 2,078 | (28.3) | 85.5 | (1.0) |
| Effective tax rate (%) | NA | 34 | 42 | 75 | | | |

Source: Company, Kotak Institutional Equities estimates

- ▶ **Lower-than-expected revenues and EBITDA.** Aban reported 1QFY11 revenues at ₹8.4 bn (+6.2% yoy, -17.5% qoq) below our estimated ₹9.4 bn. Aban reported 1QFY11 EBITDA of ₹5.2 bn (+10.9% yoy, -21.1% qoq) lower than our estimate of ₹5.9 bn. EBITDA margin at 61.7% (low 280 bps qoq) was below our estimated 63.3%. The negative variance was on account of (1) lower usage days and (2) higher employee cost due to annual bonus payouts.
- ▶ **One-off loss on account of Aban Pearl.** We note that the company provided for ₹3.4 bn on account of the loss of Aban Pearl (after adjusted for the insurance claim received).
- ▶ **Diminution in the value of investment for ₹137 mn.** The company made provision of ₹137 mn in 1QFY11 as diminution in the value of investment in Petrojack which filed for bankruptcy in March 2010. We note that (1) Aban's investment in Petrojack (20% stake) stood at ₹1.94 bn as on March 31, 2009 and (2) Aban made provision of ₹1.2 bn in 1QFY11 as diminution in the value of investment.

Earnings revision

We have revised our earnings estimates for Aban to ₹154 (-10.6%), ₹139.3 (+34.4%) and ₹148.5 (+34.2%) for FY2011E-13E. We note that the revision in EBITDA estimates is relatively moderate at -5.7% for FY2011E, +5% for FY2012E and +5.6% for FY2013E. However, the impact on net income is on account of (1) lower depreciation due to the write-off of Aban Pearl from the books of accounts and (2) lower interest expense as cash received as insurance claim with reduce the debt of the company.

Our DCF-based valuation for Aban is ₹935 per share

Aban Offshore, DCF-based valuation, March fiscal year-ends (₹ mn)

| | 2011E | 2012E | 2013E | 2014E | 2015E | 2016E | 2017E | 2018E | 2019E | 2020E | 2021E | 2022E | Terminal value |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|----------------|
| EBITDA | 22,368 | 21,744 | 21,481 | 21,635 | 22,658 | 22,979 | 24,211 | 24,633 | 24,884 | 25,513 | 25,513 | 25,513 | |
| Tax expense | (4,707) | (4,112) | (4,298) | (4,293) | (4,537) | (4,637) | (4,997) | (5,087) | (5,165) | (5,273) | | | |
| Income from joint venture | 1,420 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | | | |
| Changes in working capital | 6,133 | 460 | (591) | (38) | (574) | 50 | (629) | (178) | (105) | (320) | | | |
| Cash flow from operations | 25,214 | 18,192 | 16,692 | 17,404 | 17,647 | 18,492 | 18,685 | 19,468 | 19,714 | 20,020 | | | |
| Capital expenditure | (750) | (709) | (737) | (878) | (819) | (960) | (714) | (680) | (684) | (562) | | | |
| Cash flow from insurance of Aban Pearl | 10,810 | | | | | | | | | | | | |
| Free cash flow to the firm | 35,273 | 17,483 | 15,955 | 16,526 | 16,828 | 17,532 | 17,970 | 18,787 | 19,031 | 19,459 | 19,459 | 19,459 | 162,154 |
| Discounted cash flow-now | 32,700 | 14,471 | 11,791 | 10,905 | 9,914 | 9,222 | 8,440 | 7,878 | 7,125 | 6,505 | | | |
| Discounted cash flow-1 year forward | | 16,207 | 13,206 | 12,213 | 11,104 | 10,329 | 9,453 | 8,824 | 7,980 | 7,286 | 6,505 | | |
| Discounted cash flow-2 year forward | | | 14,791 | 13,679 | 12,437 | 11,568 | 10,587 | 9,883 | 8,938 | 8,160 | 7,286 | 6,505 | |
| Discount rate | 12.0% | | | | | | | | | | | | |
| Growth from FY2020E to perpetuity | 0.0% | | | | | | | | | | | | |

| Fiscal Year end | March-11 | March-12 | March-13 | March-14 | March-15 | March-16 | March-17 | March-18 | March-19 | March-20 |
|--------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Today | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 | 30-Jul-10 |
| Days left | 244 | 609 | 974 | 1,339 | 1,704 | 2,069 | 2,434 | 2,799 | 3,164 | 3,529 |
| Years left | 0.7 | 1.7 | 2.7 | 3.7 | 4.7 | 5.7 | 6.7 | 7.7 | 8.7 | 9.7 |
| Discount factor at WACC | 0.93 | 0.83 | 0.74 | 0.66 | 0.59 | 0.53 | 0.47 | 0.42 | 0.37 | 0.33 |

| | Now | + 1-year | + 2-years | Sensitivity of share price to WACC and growth rate (Rs) | | | | | |
|---------------------------------------|----------------|----------------|----------------|---|-------|-------|------------|-------|-----|
| | | | | WACC (%) | | | | | |
| | | | | 11.0% | 11.5% | 12.0% | 12.5% | 13.0% | |
| Total PV of free cash flow (a) | 118,952 | 103,107 | 103,833 | | | | | | |
| PV of terminal value (b) | 54,208 | 54,208 | 54,208 | | | | | | |
| EV (a) + (b) | 173,160 | 157,316 | 158,041 | | | | | | |
| Net debt | 142,541 | 116,758 | 106,349 | | | | | | |
| Equity value | 30,619 | 40,557 | 51,692 | | | | | | |
| No. of shares (# mn) | 43.5 | 43.5 | 43.5 | | | | | | |
| Implied share price (Rs) | 704 | 932 | 1,188 | | | | | | |
| Exit EV/EBITDA multiple (X) | 6.4 | | | | | | | | |
| Exit FCF multiple (X) | 8.3 | | | | | | | | |
| | | | | Growth rate (%) | | | | | |
| | | | | -1.5% | 1,068 | 917 | 777 | 648 | 528 |
| | | | | -1.0% | 1,128 | 970 | 825 | 691 | 566 |
| | | | | -0.5% | 1,194 | 1,028 | 877 | 737 | 607 |
| | | | | 0.0% | 1,265 | 1,091 | 932 | 786 | 651 |
| | | | | 0.5% | 1,343 | 1,160 | 993 | 840 | 699 |
| | | | | 1.0% | 1,430 | 1,236 | 1,059 | 898 | 751 |
| | | | | 1.5% | 1,525 | 1,318 | 1,132 | 962 | 807 |

Source: Kotak Institutional Equities estimates

Profit model, balance sheet, cash model (consolidated) for Aban Offshore, March fiscal year-ends, 2008-2012E (₹ mn)

| | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E |
|--|-----------------|-----------------|----------------|----------------|----------------|----------------|
| Profit model | | | | | | |
| Total income | 20,211 | 30,501 | 33,587 | 37,365 | 37,931 | 38,581 |
| EBITDA | 12,691 | 17,638 | 21,003 | 22,368 | 21,744 | 21,481 |
| Interest expense | (6,533) | (8,725) | (9,768) | (8,567) | (7,782) | (6,541) |
| Depreciation | (2,549) | (4,414) | (4,616) | (5,268) | (5,004) | (4,982) |
| Other income | 733 | 224 | 219 | 299 | 301 | 305 |
| Pretax profits | 4,342 | 4,722 | 6,838 | 8,831 | 9,259 | 10,262 |
| Extra ordinary items | (2,536) | 2,080 | (2,408) | (3,359) | — | — |
| Reported PBT | 1,807 | 6,802 | 4,430 | 5,473 | 9,259 | 10,262 |
| Tax | (1,514) | (2,646) | (2,651) | (3,296) | (3,198) | (3,857) |
| Deferred taxation | 84 | 138 | 80 | 24 | — | — |
| Profit after tax | 377 | 4,294 | 1,860 | 2,201 | 6,061 | 6,406 |
| Joint venture/ minority | 853 | 1,113 | 1,250 | 1,420 | 100 | 100 |
| Reported consolidated net profit | 1,230 | 5,407 | 3,110 | 3,622 | 6,161 | 6,506 |
| Adjusted net profit | 2,954 | 3,951 | 4,121 | 6,980 | 6,161 | 6,506 |
| Diluted earnings per share (Rs) | 70.8 | 96.9 | 88.3 | 154.1 | 139.3 | 148.5 |
| Balance sheet | | | | | | |
| Total equity | 5,063 | 14,188 | 18,546 | 20,695 | 26,534 | 32,755 |
| Preference capital | 3,060 | 3,260 | 3,260 | 3,260 | 1,250 | 600 |
| Deferred taxation liability | 654 | 516 | 436 | 411 | 411 | 411 |
| Total borrowings | 130,434 | 166,355 | 141,641 | 118,029 | 106,497 | 97,109 |
| Current liabilities | 7,517 | 14,090 | 9,342 | 12,780 | 13,099 | 13,538 |
| Total liabilities and equity | 146,727 | 198,408 | 173,224 | 155,175 | 147,792 | 144,414 |
| Cash | 6,453 | 5,948 | 2,360 | 4,531 | 1,398 | 1,198 |
| Other current assets | 7,637 | 11,106 | 12,269 | 9,576 | 9,621 | 10,689 |
| Goodwill | 44,289 | 55,991 | 49,612 | 50,771 | 50,771 | 50,771 |
| Tangible fixed assets | 81,958 | 119,612 | 104,033 | 85,347 | 81,052 | 76,806 |
| Investments | 6,391 | 5,751 | 4,951 | 4,951 | 4,951 | 4,951 |
| Total assets | 146,727 | 198,408 | 173,225 | 155,175 | 147,792 | 144,414 |
| Free cash flow | | | | | | |
| Operating cash flow, excl. working capital | 3,146 | 10,306 | (6,224) | 22,542 | 10,677 | 11,080 |
| Working capital changes | (1,654) | 2,313 | (5,943) | 6,133 | 460 | (591) |
| Capital expenditure | (32,638) | (50,742) | 10,964 | (750) | (709) | (737) |
| Investment changes | (386) | 2,314 | 800 | — | — | — |
| Other income | 458 | 245 | 383 | 492 | 488 | 408 |
| Free cash flow | (31,074) | (35,564) | (19) | 28,417 | 10,917 | 10,160 |
| Ratios (%) | | | | | | |
| EBITDA margin | 62.8 | 57.8 | 62.5 | 59.9 | 57.3 | 55.7 |
| Debt/equity | 2,335 | 1,154 | 763 | 575 | 399.9 | 294.6 |
| Net debt/equity | 2,143 | 1,113 | 751 | 553 | 394.7 | 291.0 |
| RoAE | 51.7 | 26.9 | 21.7 | 33.1 | 22.9 | 19.6 |
| RoACE | 3.4 | 5.9 | 4.7 | 6.8 | 8.1 | 8.0 |

Source: Company, Kotak Institutional Equities estimates

JULY 30, 2010

RESULT

Coverage view: **Cautious**

Price (Rs): **110**

Target price (Rs): **110**

BSE-30: **17,992**

Steady quarter. PVKP reported 1QFY11 revenues of ₹1.2 bn (+108% yoy) and EBITDA of ₹391 mn which is 5% above our estimate. PAT of ₹359 mn for 1QFY11 was 23% higher than our expectation of ₹292 mn due to tax adjustments. PVKP has made good progress on the affordable housing projects under Provident Housing. The management has indicated a strong launch pipeline for FY2011E. We maintain our REDUCE rating with a target price ₹110 at a 20% discount to our estimated NAV.

Company data and valuation summary

Puravankara Projects

Stock data

| | |
|-------------------------------|--------|
| 52-week range (Rs) (high,low) | 137-75 |
| Market Cap. (Rs bn) | 23.6 |

Shareholding pattern (%)

| | |
|-----------|------|
| Promoters | 90.0 |
| FIs | 6.4 |
| MFs | 0.2 |

Price performance (%)

| | 1M | 3M | 12M |
|----------------|-----|-------|------|
| Absolute | 4.1 | (0.6) | 17.5 |
| Rel. to BSE-30 | 2.4 | (3.0) | 0.5 |

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|-------|-------|-------|
| EPS (Rs) | 6.4 | 8.2 | 8.1 |
| EPS growth (%) | (5.2) | 28.4 | (2.0) |
| P/E (X) | 17.2 | 13.4 | 13.7 |
| Sales (Rs bn) | 4.8 | 6.6 | 8.2 |
| Net profits (Rs bn) | 1.4 | 1.8 | 1.7 |
| EBITDA (Rs bn) | 1.5 | 2.2 | 2.5 |
| EV/EBITDA (X) | 21.5 | 14.5 | 14.2 |
| ROE (%) | 10.0 | 11.9 | 10.7 |
| Div. Yield (%) | 1.8 | 1.8 | 1.8 |

1QFY11 results above estimates

PVKP reported 1QFY11 revenues of ₹1.2 bn (+108% yoy, -5% qoq) versus our estimate of ₹1.1 bn. EBITDA of ₹391 mn (+306% yoy, 5% above KIE estimate and +15% qoq) indicates a return of some stability to reported financials. PAT at ₹359 mn was higher than our estimate due to higher EBITDA and lower tax rate (9% versus 20% expected).

Encouraging response to new launches

PVKP launched Purva Skywood (0.7 mn sq. ft) in Bangalore at Sarjapur Road in June 2010 at a price of around ₹3,000/ sq. ft. Over FY2011E, PVKP is planning to launch 12 mn sq. ft of real estate— 4 mn sq. ft in Chennai (relaunch of Windmere), 4 mn sq. ft in Bangalore (Sarjapur, Dollars Colony) and 4 mn sq. ft in Kochi (Edapally). PVKP currently has 11.7 mn sq. ft of projects under execution including 12 residential projects (8.6 mn sq. ft), two recently launched affordable housing projects (2.7 mn sq. ft) and 2 commercial projects (0.5 mn sq. ft).

Total land area has increased to 61 mn sq. ft (10.5 ongoing + 50.5 future) versus 44.2 mn sq. ft (10.1 ongoing + 34.1 future) after virtually stagnating for more than a year.

There have been no handovers in the quarter. Ongoing projects are all South India focused except for Elita Garden Vista in Kolkata. Both commercial projects are in Chennai. At present 97% of their portfolio is residential and PVKP intends to move towards its long term goal of 20-25% commercial projects once the commercial / leasing market picks up.

Maintain REDUCE with a target price of Rs110

We maintain our REDUCE rating with a target price of ₹110. Our target price is based on a 20% discount to September-2011 NAV of ₹138/share. We factor in a discount of 20% to account for continued mismatch between cash flows and debt/interest servicing. Balance sheet improvement will hinge on the company's ability to generate operating cash flows or on further equity fund raising, which in turn will be dependent on the success of affordable housing projects.

QUICK NUMBERS

- 11.7 mn sq. ft of ongoing projects
- D/E remains steady at 0.57X

Ajay Mathrani

ajay.mathrani@kotak.com
Mumbai: +91-22-6634-1376

Dhruva Acharya

dhruva.acharya@kotak.com
Mumbai: +91-22-6634-1417

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

1QFY11 results are above estimates

Interim results, Puravankara, March fiscal year-ends (₹ mn)

| (in Rs mn) | 1QFY11 | 1QFY11E | 1QFY10 | 4QFY10 | (% chg) | | |
|-------------------------------|--------------|--------------|--------------|--------------|-------------|--------------|---------------|
| | | | | | 1QFY11E | 1QFY10 | 4QFY10 |
| Net sales | 1,163 | 1,064 | 560 | 1,228 | 9.3 | 107.8 | (5.3) |
| Operating costs | (772) | (692) | (464) | (890) | 11.7 | 66.6 | (13.2) |
| Cost of revenues | (664) | | (384) | (784) | | 73.0 | (15.4) |
| G&A | (72) | | (63) | (73) | | 14.5 | (1.2) |
| Selling expense | (37) | | (17) | (33) | | 114.6 | 12.6 |
| EBITDA | 391 | 372 | 96 | 339 | 4.9 | 305.9 | 15.4 |
| One-off items | | | | | | | |
| Other income | | — | — | — | | | |
| Interest costs | 3 | (5) | 3 | 3 | (156.4) | 0.0 | 7.1 |
| Depreciation | — | — | — | — | | | |
| PBT | 394 | 367 | 99 | 341 | 7.2 | 296.7 | 15.3 |
| Taxes | (34) | (75) | (1) | 39 | (54.3) | 2546.2 | (187.5) |
| PAT | 359 | 292 | 98 | 381 | 23.1 | 266.8 | (5.6) |
| Share of profit in associates | 8 | 9 | 5 | 57 | (17.9) | 73.3 | (86.2) |
| Consolidated PAT | 367 | 301 | 102 | 437 | 21.8 | 258.3 | (16.1) |
| Key ratios | | | | | | | |
| EBITDA margin (%) | 33.6 | 35.0 | 17.2 | 27.6 | | | |
| PAT margin (%) | 30.9 | 27.4 | 17.5 | 31.0 | | | |
| Effective tax rate (%) | 8.7 | 20.5 | 1.3 | (11.5) | | | |

Source: Company, Kotak Institutional Equities estimates

We have a target price of ₹110 /share

NAV-based valuation, Puravankara, March fiscal year-ends (₹ bn)

| | March '10 based NAV | | | |
|--|-------------------------------|-------------|-------------|-------------|
| | Growth rate in selling prices | | | |
| | 0% | 3% | 5% | 10% |
| Valuation (Rs bn) | 16.3 | 28.6 | 37.7 | 64.1 |
| Residential | 16.8 | 23.9 | 29.1 | 44.1 |
| Retail | 0.5 | 0.7 | 0.9 | 1.3 |
| Commercial | (1.1) | 3.9 | 7.7 | 18.8 |
| Less: Net debt | (8.0) | (8.0) | (8.0) | (8.0) |
| NAV | 8.3 | 20.6 | 29.7 | 56.1 |
| NAV/share | 39 | 96 | 138 | 261 |
| Total no. of shares | | | | 214.5 |
| Target price @20% discount to NAV | | | | 110 |

Source: Company, Kotak Institutional Equities

One new launch and no deliveries in 1QFY11

PVKP launched Purva Skywood (0.7 mn sq. ft) in Bangalore at Sarjapur Road in June 2010 and there have been no handovers in the quarter. Ongoing projects are all South India focused except for Elita Garden Vista in Kolkata. Both these commercial projects are in Chennai. At present 97% of their portfolio is residential and PVKP intends to move towards its long-term goal of 20-25% commercial projects once the commercial / leasing market picks up.

Puravankara has 11.7 mn sq. ft of ongoing projects
Ongoing Projects, Puravankara, Q1FY2011

| Name of the project | Year of launch | City | Developable | | Launched (mn sq. ft) |
|--------------------------------|----------------|-----------|---------------------|----------------------|-------------------------|
| | | | Area (mn sq. ft) | No. of apartments | |
| Puravankara Residential | | | | | |
| Purva Atria -1 | Jan-06 | Bangalore | 0.24 | 131 | 0.15 |
| Elita Promenade | Jun-06 | Bangalore | 2.55 | 1,573 | 1.25 |
| Purva Venezia | Jan-06 | Bangalore | 2.09 | 1,332 | 2.09 |
| Purva Highlands | Oct-06 | Bangalore | 2.54 | 1,589 | 1.36 |
| Purva Grand Bay | Dec-05 | Kochi | 0.50 | 265 | 0.50 |
| Purva Eternity | Apr-06 | Kochi | 0.96 | 600 | 0.80 |
| Purva Swanlake | Apr-07 | Chennai | 0.83 | 522 | 0.83 |
| Atria Platina | | Bangalore | 0.14 | 70 | 0.09 |
| Moon Reach | Jun-07 | Kochi | 0.39 | 196 | 0.15 |
| Oceana | Sep-07 | Kochi | 0.26 | 96 | 0.26 |
| Elita Garden Vista | Dec-07 | Kolkata | 2.28 | 1,278 | 0.44 |
| Purva Skywood | | Bangalore | 1.24 | 730 | 0.69 |
| Total Residential | | | 14.03 | 8,382 | 8.61 |
| Provident Housing | | | | | |
| Cosmos City | Mar-09 | Chennai | 2.23 | 2,174 | 1.50 |
| Welworth City | Jul-09 | Bangalore | 3.46 | 3,360 | 1.15 |
| Total Provident Housing | | | 5.69 | 5,534 | 2.65 |
| Puravankara Commercial | | | | | |
| Moneta | | Chennai | 0.36 | | 0.36 |
| Primus | | Chennai | 0.17 | | 0.10 |
| Total Commercial | | | 0.53 | | 0.46 |
| Total | | | 20.25 | 13,916 | 11.73 |

Source: Company, Kotak Institutional Equities

Other details

- ▶ Total land area has increased to 61 mn sq. ft (10.5 ongoing + 50.5 future) versus 44.2 mn sq. ft (10.1 ongoing + 34.1 future) after virtually stagnating for more than a year.
- ▶ D/E remained steady at 0.57x versus 0.54x as of end-4QFY10 and 0.58x as of end-1QFY10.

Consolidated summary statement of assets and liabilities
Quarterly Balance Sheet, Puravankara, March fiscal year-ends (₹ mn)

| Particulars | Mar-08 | Jun-08 | Sep-08 | Dec-08 | Mar-09 | Jun-09 | Sep-09 | Dec-09 | Mar-10 | Jun-10 |
|---|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Net fixed assets | 497 | 493 | 484 | 477 | 463 | 452 | 440 | 430 | 362 | 355 |
| Investments | 887 | 928 | 967 | 998 | 1,038 | 1,043 | 1,071 | 1,134 | 1,191 | 1,199 |
| Current assets, loans and advances | 9,090 | 9,707 | 10,235 | 10,842 | 11,051 | 11,384 | 12,870 | 12,442 | 12,658 | 12,905 |
| Cash and cash equivalents | 350 | 396 | 374 | 698 | 268 | 262 | 276 | 812 | 782 | 556 |
| Inventories | 171 | 169 | 194 | 191 | 197 | 189 | 175 | 229 | 227 | 207 |
| Trade debtors | 824 | 863 | 1,028 | 1,047 | 1,146 | 1,244 | 2,499 | 1,268 | 1,112 | 1,202 |
| Properties under development | 3,958 | 4,354 | 4,800 | 5,093 | 5,700 | 6,025 | 6,390 | 6,485 | 6,802 | 7,151 |
| Properties held for sale | 910 | 865 | 865 | 948 | 974 | 946 | 915 | 873 | 852 | 823 |
| Loans and advances | 2,878 | 3,060 | 2,974 | 2,865 | 2,766 | 2,718 | 2,614 | 2,774 | 2,883 | 2,967 |
| Properties held for development | 12,919 | 13,016 | 13,630 | 13,839 | 13,924 | 13,995 | 13,338 | 13,393 | 13,528 | 13,597 |
| Total application of funds | 23,393 | 24,144 | 25,317 | 26,157 | 26,476 | 26,873 | 27,718 | 27,400 | 27,739 | 28,057 |
| Total loans | 6,524 | 6,524 | 8,050 | 8,269 | 8,146 | 8,297 | 8,326 | 8,326 | 8,811 | 9,168 |
| Current liabilities and provisions | 4,732 | 4,858 | 3,997 | 4,366 | 4,659 | 4,802 | 5,007 | 4,384 | 4,068 | 3,680 |
| Deferred tax liability (net) | 10 | 17 | 19 | 21 | 23 | 23 | 25 | 25 | 9 | 9 |
| Shareholders funds | 12,127 | 12,746 | 13,251 | 13,501 | 13,649 | 13,751 | 14,360 | 14,665 | 14,852 | 15,201 |
| Total sources of fund | 23,394 | 24,145 | 25,317 | 26,157 | 26,476 | 26,873 | 27,718 | 27,400 | 27,739 | 28,057 |

Source: Company, Kotak Institutional Equities estimates

Profit model of Puravankara

March fiscal year-ends, 2008-20013E (₹ mn)

| | 2008 | 2009 | 2010 | 2011E | 2012E | 2013E |
|-----------------------------------|--------------|--------------|--------------|--------------|--------------|---------------|
| Total revenues | 5,658 | 4,449 | 4,783 | 6,649 | 8,241 | 13,382 |
| Land costs | (316) | (282) | (986) | (226) | (271) | (500) |
| Construction costs | (2,756) | (2,315) | (1,664) | (3,661) | (4,839) | |
| Selling expenses | (225) | (216) | (171) | (332) | (330) | (535) |
| G&A expenses | (240) | (271) | (271) | (266) | (288) | (468) |
| EBITDA | 2,122 | 1,366 | 1,691 | 2,164 | 2,514 | 4,206 |
| Other income | 135 | 46 | 44 | 45 | 45 | 45 |
| Interest | (36) | (38) | (29) | (235) | (347) | (504) |
| Depreciation | (48) | (54) | (111) | (131) | (171) | (235) |
| Pretax profits | 2,173 | 1,319 | 1,596 | 1,843 | 2,040 | 3,511 |
| Profit/(loss) share of associates | 295 | 151 | 152 | 188 | 365 | 381 |
| Current tax | (68) | (13) | (312) | (316) | (715) | (1,218) |
| Deferred tax | 1 | (13) | 14 | 30 | 21 | 25 |
| Net income | 2,400 | 1,444 | 1,451 | 1,745 | 1,711 | 2,699 |
| EPS (Rs) | | | | | | |
| Primary | 11.5 | 6.8 | 6.8 | 8.2 | 8.0 | 12.6 |
| Fully diluted | 11.5 | 6.8 | 6.8 | 8.2 | 8.0 | 12.6 |
| Shares outstanding (mn) | | | | | | |
| Year end | 213 | 213 | 213 | 213 | 213 | 213 |
| Primary | 208 | 213 | 213 | 213 | 213 | 213 |
| Fully diluted | 208 | 213 | 213 | 213 | 213 | 213 |
| Cash flow per share (Rs) | | | | | | |
| Primary | 6.6 | 6.5 | 11.3 | 9.5 | 10.1 | 16 |
| Fully diluted | 6.6 | 6.5 | 11.3 | 9.5 | 10.1 | 16 |
| Growth (%) | | | | | | |
| Net income (adjusted) | 84 | (40) | 0 | 20 | (2) | 58 |
| EPS (adjusted) | 70 | (41) | 0 | 20 | (2) | 58 |
| DCF/share | (26) | (2) | 74 | (16) | 6 | 56 |
| Cash tax rate (%) | 3 | 1 | 20 | 17 | 35 | 35 |
| Effective tax rate (%) | 3 | 2 | 19 | 16 | 34 | 34 |

Source: Company, Kotak Institutional Equities estimates

Balance sheet of Puravankara
March fiscal year-ends, 2008-2013E (₹ mn)

| | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E |
|--------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Equity | | | | | | |
| Share capital | 1,067 | 1,067 | 1,067 | 1,067 | 1,067 | 1,067 |
| Reserves/surplus | 11,060 | 12,582 | 13,785 | 15,043 | 16,267 | 18,966 |
| Total equity | 12,127 | 13,649 | 14,852 | 16,110 | 17,334 | 20,033 |
| Deferred tax liability/(asset) | 10 | 23 | 9 | (21) | (43) | (68) |
| Liabilities | | | | | | |
| Secured loans | 5,774 | 8,106 | 8,726 | 8,522 | 12,522 | 18,022 |
| Unsecured loans | 750 | 40 | 85 | 11 | 11 | 11 |
| Total borrowings | 6,524 | 8,146 | 8,811 | 8,533 | 12,533 | 18,033 |
| Current liabilities | 4,732 | 4,659 | 4,068 | 4,996 | 5,999 | 7,390 |
| Total capital | 23,394 | 26,476 | 27,739 | 29,618 | 35,824 | 45,389 |
| Assets | | | | | | |
| Cash | 350 | 268 | 782 | 1,488 | 1,203 | 1,791 |
| Current assets | 21,660 | 24,707 | 25,404 | 25,064 | 27,383 | 28,376 |
| Gross block | 611 | 632 | 642 | 1,071 | 4,475 | 7,360 |
| Less: accumulated depreciation | 115 | 169 | 280 | 411 | 582 | 817 |
| Net fixed assets | 497 | 463 | 362 | 660 | 3,894 | 6,543 |
| Capital work-in-progress | - | - | - | 1,215 | 2,155 | 7,488 |
| Total fixed assets | 497 | 463 | 362 | 1,875 | 6,048 | 14,030 |
| Intangible assets | — | — | — | — | — | — |
| Investments | 887 | 1,038 | 1,191 | 1,191 | 1,191 | 1,191 |
| Misc. expenses | — | — | — | — | — | — |
| Total assets | 23,394 | 26,477 | 27,739 | 29,618 | 35,824 | 45,389 |
| Leverage ratios (%) | | | | | | |
| Debt/equity | 53.8 | 59.6 | 59.3 | 53.0 | 72.5 | 90.3 |
| Debt/capitalization | 35.0 | 37.3 | 37.2 | 34.7 | 42.0 | 47.5 |
| Net debt/equity | 50.9 | 57.6 | 54.0 | 43.8 | 65.5 | 81.4 |
| Net debt/capitalization | 33.7 | 36.6 | 35.1 | 30.5 | 39.6 | 44.9 |
| RoAE | 33.4 | 11.2 | 10.2 | 11.3 | 10.3 | 14.5 |
| RoACE | 15.5 | 6.6 | 5.7 | 7.1 | 5.7 | 7.7 |

Source: Company, Kotak Institutional Equities estimates

JULY 29, 2010

RESULT

Coverage view: **Attractive**

Price (Rs): **82**

Target price (Rs): **72**

BSE-30: **17,992**

Revenues rebound; margin disappointment prevents re-rating. Hexaware reported a sharp rebound in revenues, reporting 13% qoq US\$ revenue growth, higher than guidance as well as expectations. The company also indicated demand momentum sustenance with 5.5-7.5% qoq revenue growth guidance for 3QCY10E. However, cost pressures manifested, leading to a 140 bps qoq decline in OPM. More importantly, poor margin outlook will likely prevent near-term re-rating of the stock. Retain REDUCE.

Company data and valuation summary

Hexaware Technologies

Stock data

| | |
|-------------------------------|--------|
| 52-week range (Rs) (high,low) | 103-60 |
| Market Cap. (Rs bn) | 11.8 |

Shareholding pattern (%)

| | |
|-----------|------|
| Promoters | 28.5 |
| FIs | 44.1 |
| MFs | 2.9 |

Price performance (%)

| | 1M | 3M | 12M |
|----------------|-----|------|------|
| Absolute | 9.1 | 15.7 | 30.9 |
| Rel. to BSE-30 | 6.3 | 12.6 | 10.4 |

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|-------|--------|-------|
| EPS (Rs) | 9.3 | 5.0 | 9.4 |
| EPS growth (%) | 127.7 | (46.3) | 87.7 |
| P/E (X) | 8.8 | 16.3 | 8.7 |
| Sales (Rs bn) | 10.4 | 10.3 | 12.9 |
| Net profits (Rs bn) | 1.3 | 0.7 | 1.4 |
| EBITDA (Rs bn) | 2.0 | 0.9 | 1.5 |
| EV/EBITDA (X) | 4.4 | 10.4 | 5.3 |
| ROE (%) | 17.8 | 8.2 | 14.0 |
| Div. Yield (%) | 1.2 | 1.2 | 1.2 |

Strong revenue growth and a strong guidance but.....

Hexaware reported revenues of US\$54.9 mn for 2QCY10 (+13% qoq, 4.6% higher than our estimate); we do note that this is on the back of a weak 1QCY10, where the company saw a sharp 10% qoq decline in revenues. However, strong 5.5-7.5% qoq revenue growth guidance for 3QCY10, a large (US\$100 mn+) deal win, and robust headcount addition lend comfort to the sustenance of reasonable revenue growth trajectory over the coming quarters.

.....margins performance disappointing and outlook cloudy, at best

The strongest sequential revenue growth in the past 4 years was not good enough to arrest the decline in margins – margins which had fallen to a low of 8.2% in 1QCY10 fell further by 140 bps to 6.8% for 2QCY10. Margins were impacted by (1) impact of offshore wage hike of 15% effected from April 1, 2010, (2) adverse cross-currency movements and (3) transition costs incurred on a new large deal. Despite a handsome revenue beat, Hexaware's EBITDA of Rs170 mn missed our expectations by 11.6%.

Net income outperformance (Rs144 mn versus our estimated Rs109 mn) was entirely driven by higher other income – we note that the company booked gains from sale of a building in Navi Mumbai, during the quarter.

Concerns on margins prevent re-rating; reiterate REDUCE

Hexaware's margin miss was in line with the margin trends seen across the mid-sized companies. Ongoing bench correction across companies spurred by the sharp, strong demand rebound has created a vicious attrition cycle in the industry, putting immense pressure on cost of hiring laterals and creating internal imbalances. As emphasized in some of our recent notes, we expect another round of interim wage hikes (may not be across the board, but selective) in the industry. We also find the mid-sized companies in a weaker position to manage the cost-of-delivery pressure as compared to the larger ones. Our CY2010/11E EPS estimates for Hexaware are largely unchanged despite a sharp increase in revenue estimates as we build in further margin pressure. Reiterate REDUCE with an unchanged target price of Rs72/share.

Kawaljeet Saluja
kawaljeet.saluja@kotak.com
Mumbai: +91-22-6634-1243

Rohit Chordia
rohit.chordia@kotak.com
Mumbai: +91-22-6634-1397

Vineet Thodge
vineet.thodge@kotak.com
Mumbai: +91-22-6634-1225

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

2QCY10 highlights; revenue positives marred by margin negatives

- ▶ Revenue performance (+13% qoq) and guidance for 3QCY10E (+5.5-7.5% qoq) reinforced our positive outlook on the demand environment for the Indian IT services players.
- ▶ Hexaware also announced a large US\$110 mn 5-year deal with an existing North American customer (incremental revenues of US\$70 mn), in addition to a US\$60 mn 3-year contract extension with one of its top customers.
- ▶ Headcount addition was strong at 727 (net) for the quarter as the company continues to ramp its bench to meet growth estimates and take care of attrition challenges.
- ▶ Receivables management was impressive with DSO declining 9 days qoq to 53 from 62 in the previous quarter.
- ▶ Margin performance was disappointing (OPM down 140 bps qoq). More importantly, near-term outlook of margins is muted as (1) the company will effect its 3.5% average onsite wage hikes in the Sep 10 quarter, (2) upfront transition costs on the large deal hit margins, and (3) bench correction keeps utilization improvement in check.

Maintain EPS estimates, target price and REDUCE rating

We broadly maintain our CY2010E/11E EPS estimate at Rs5.0/9.4. Upside from increased revenue estimates (CY2010E revenue estimate raised 3.4% to US\$225 mn, and CY2011E estimate raised by 8% to US\$281 mn) is mitigated by lowered margin assumptions. Exhibit 1 details the key changes in our earnings model. We retain our REDUCE rating on the stock with an unchanged target price of Rs72/share.

Exhibit 1: Key changes in CY2010-11E estimates

| | New | | Old | | Change (%) | |
|---------------------------|-------------|-------------|-------------|-------------|--------------|------------|
| | CY2010 | CY2011 | CY2010 | CY2011 | CY2010 | CY2011 |
| Revenues (US\$ mn) | 225 | 281 | 217 | 260 | 3.4 | 8.0 |
| EBITDA Margin (%) | 8.3 | 12.0 | 9.8 | 13.3 | | |
| EPS (Rs/ share) | 5.0 | 9.4 | 5.1 | 9.4 | (1.6) | 0.4 |
| Re/ US\$ rate | 45.9 | 45.9 | 44.5 | 44.8 | 3.1 | 2.4 |

Source: Kotak Institutional Equities estimates

Exhibit 2: Hexaware Interim Results (consolidated), 2QCY10

| Rs mn | 2QCY09 | 1QCY10 | 2QCY10 | % chg. | | Kotak estimates | % deviation |
|-------------------------------------|--------------|--------------|--------------|--------------|---------------|-----------------|---------------|
| | | | | qoq | yoy | | |
| Revenue (US\$ mn) | 53.6 | 48.6 | 54.9 | 13.0 | 2.4 | 53 | 4.6 |
| Revenues | 2,591 | 2,220 | 2,512 | 13.2 | (3.0) | 2,394 | 4.9 |
| Software Development Costs | (1,357) | (1,421) | (1,659) | 16.7 | 22.3 | (1,549) | 7.1 |
| Gross profit | 1,234 | 799 | 853 | 6.8 | (30.9) | 845 | 1.0 |
| Total SG&A Expenses | (676) | (617) | (683) | 10.7 | 1.0 | (653) | 4.7 |
| EBITDA | 558 | 182 | 170 | (6.6) | (69.5) | 192 | (11.6) |
| Depreciation | (71) | (59) | (59) | — | (16.9) | (63) | (6.6) |
| EBIT | 487 | 123 | 111 | (9.8) | (77) | 129 | (14.0) |
| Other Income | (45) | 2 | 80 | 3,900 | (278) | (5) | (1,601) |
| Profit Before Tax | 442 | 125 | 191 | 52.8 | (56.8) | 124 | 54.3 |
| Provision for Tax | (46) | (9) | (19) | 111.1 | (58.7) | (14) | 32.0 |
| Net Profit | 396 | 116 | 172 | 48.3 | (56.6) | 109 | 57.3 |
| Extraordinary items | — | — | (28) | | | — | |
| Net Profit- Reported | 396 | 116 | 144 | 24.1 | (63.6) | 109 | 31.7 |
| EPS (Rs/ share) | 2.8 | 0.8 | 1.2 | 48.3 | (56.6) | 0.76 | 57.3 |
| No of shares outstanding (mn) | 143.7 | 143.7 | 143.7 | | | 143.7 | |
| As % of revenues | | | | | | | |
| Gross Profit Margin (%) | 47.6 | 36.0 | 34.0 | | | 35.3 | |
| Operating Margin | 21.5 | 8.2 | 6.8 | | | 8.0 | |
| SG&A Expenses (%) | 26.1 | 27.8 | 27.2 | | | 27.3 | |
| Billing Rates (US\$/manhour) | | | | | | | |
| Onsite | 68.3 | 72.9 | 69.0 | (5.3) | 1.1 | | |
| Offshore | 23.0 | 22.4 | 21.6 | (3.7) | (6.2) | | |
| Revenue Mix (%) | | | | | | | |
| Onsite | 58.9 | 60.3 | 60.3 | | | | |
| Offshore | 41.1 | 39.7 | 39.7 | | | | |

Hexaware has guided for US\$58-59 mn revenues for 3QCY10, an increase of 5.5-7.5% qoq

Source: Company, Kotak Institutional Equities estimates

Exhibit 3: Consolidated financials for Hexaware, 2008-2011E, December fiscal year-ends (Rs mn)

| | 2008 | 2009 | 2010E | 2011E |
|---|---------------|---------------|---------------|---------------|
| Profit model | | | | |
| Total income | 11,520 | 10,386 | 10,310 | 12,895 |
| EBITDA | 1,289 | 2,023 | 858 | 1,545 |
| Depreciation (incl amortization of intangibles) | (270) | (270) | (250) | (295) |
| Other income | (274) | (307) | 223 | 490 |
| Pretax profits | 744 | 1,446 | 831 | 1,742 |
| Tax | (155) | (103) | (109) | (386) |
| Profit after tax | 590 | 1,343 | 722 | 1,356 |
| Diluted earnings per share (Rs) | 4.1 | 9.3 | 5.0 | 9.4 |
| Balance sheet | | | | |
| Total equity | 6,625 | 8,497 | 9,051 | 10,237 |
| Deferred taxation liability | (84) | (110) | (110) | (110) |
| Total borrowings | 195 | 163 | — | — |
| Current liabilities | 3,711 | 2,709 | 2,779 | 3,539 |
| Total liabilities and equity | 10,447 | 11,259 | 11,719 | 13,666 |
| Cash | 2,849 | 2,992 | 2,874 | 3,636 |
| Investments | — | 1,269 | 1,269 | 1,269 |
| Other current assets | 3,101 | 2,639 | 2,648 | 3,365 |
| Tangible fixed assets | 4,498 | 4,358 | 4,928 | 5,396 |
| Total assets | 10,447 | 11,259 | 11,719 | 13,666 |
| Free cash flow | | | | |
| Operating cash flow, excl. working capital | 1,173 | 1,732 | 749 | 1,159 |
| Working capital changes | (133) | 283 | 61 | 43 |
| Capital expenditure | (1,275) | (82) | (821) | (763) |
| Other income | (274) | (307) | 223 | 490 |
| Free cash flow | (509) | 1,627 | 212 | 930 |
| Ratios (%) | | | | |
| EBITDA margin | 11.2 | 19.5 | 8.3 | 12.0 |

Source: Company, Kotak Institutional Equities estimates

Exhibit 4: Hexaware: Quarterly key metrics

| | Jun-08 | Sep-08 | Dec-08 | Mar-09 | Jun-09 | Sep-09 | Dec-09 | Mar-10 | Jun-10 |
|---|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Revenues (US\$ mn) | 67.6 | 66.3 | 61.9 | 52.6 | 53.6 | 54.5 | 54.0 | 48.6 | 54.9 |
| qoq growth (%) | 0.9 | (1.9) | (6.6) | (15.0) | 1.9 | 1.7 | (0.9) | (10.0) | 13.0 |
| Revenues (Rs mn) | 2,845 | 2,946 | 3,059 | 2,643 | 2,591 | 2,632 | 2,520 | 2,220 | 2,512 |
| Exchange rate | 42.08 | 44.44 | 49.41 | 50.25 | 48.35 | 48.32 | 46.66 | 45.68 | 45.76 |
| Vertical split of revenues | | | | | | | | | |
| BFSI | 40.1 | 38.8 | 40.5 | 41.7 | 40.4 | 41.9 | 42.3 | 40.8 | 36.5 |
| TTHL | 17.3 | 15.1 | 15.4 | 17.1 | 17.1 | 17.1 | 18.7 | 20.0 | 21.7 |
| Emerging segments | 27.4 | 31.4 | 32.1 | 29.2 | 30.4 | 29.4 | 28.8 | 39.2 | 41.8 |
| Others | 15.2 | 14.7 | 12.0 | 12.0 | 12.1 | 11.6 | 10.2 | — | — |
| Service line split of revenues | | | | | | | | | |
| ADM | 40.4 | 38.8 | 40.4 | 44.0 | 44.7 | 46.6 | 48.5 | 49.2 | 48.0 |
| EAS | 31.2 | 33.6 | 29.4 | 28.3 | 26.7 | 26.3 | 26.1 | 23.4 | 27.8 |
| Testing / BTO | 16.1 | 13.6 | 16.3 | 13.1 | 13.9 | 11.4 | 10.0 | 10.6 | 8.1 |
| Business intelligence & analytics | 5.8 | 7.3 | 6.6 | 6.4 | 6.7 | 7.4 | 7.3 | 6.5 | 6.8 |
| BPO | 5.0 | 5.3 | 6.0 | 6.8 | 7.0 | 6.7 | 6.8 | 7.4 | 7.0 |
| Others | 1.5 | 1.4 | 1.3 | 1.4 | 1.0 | 1.6 | 1.3 | 2.9 | 2.3 |
| Geographical split of revenues (f) | | | | | | | | | |
| Americas | 61.9 | 64.1 | 67.6 | 66.1 | 65.2 | 64.6 | 67.3 | 68.7 | 65.7 |
| Europe | 31.8 | 30.2 | 26.0 | 26.1 | 27.7 | 29.2 | 26.8 | 25.4 | 28.9 |
| Rest of the world | 6.3 | 5.7 | 6.4 | 7.8 | 7.1 | 6.2 | 5.9 | 5.9 | 5.4 |
| Onsite-Offshore mix | | | | | | | | | |
| Onsite | 64.5 | 62.6 | 62.6 | 58.8 | 58.9 | 60.6 | 60.8 | 60.3 | 60.3 |
| Offshore | 35.5 | 37.4 | 37.4 | 41.2 | 41.1 | 39.4 | 39.2 | 39.7 | 39.7 |
| Client metrics | | | | | | | | | |
| Repeat business | 91.8 | 89.8 | 90.2 | 93.4 | 97.3 | 96.4 | 96.9 | 96.1 | 94.5 |
| Clients billed | 177 | 177 | 178 | 168 | 166 | 159 | 157 | 156 | 156 |
| Clients added | 10 | 4 | 12 | 9 | 10 | 9 | 7 | 9 | 12 |
| Revenue concentration (a,e) | | | | | | | | | |
| Top 1 client | 12.1 | 13.6 | 13.1 | 11.9 | 12.6 | 11.5 | 10.3 | 8.2 | 8.6 |
| Top 5 clients | 32.6 | 30.6 | 32.7 | 34.2 | 33.7 | 34.7 | 35.0 | 32.0 | 34.1 |
| Top 10 clients | 48.4 | 46.9 | 48.1 | 50.0 | 49.9 | 50.6 | 49.8 | 46.5 | 48.5 |
| Client size (d) | | | | | | | | | |
| > US\$1 mn | 56 | 56 | 56 | 51 | 49 | 47 | 47 | 47 | 49 |
| Between US\$1 mn - US\$5 mn | 43 | 43 | 43 | 40 | 40 | 38 | 39 | 39 | 40 |
| Between US\$5 mn - US\$10 mn | 9 | 9 | 9 | 7 | 6 | 6 | 4 | 4 | 5 |
| > US\$10 mn | 4 | 4 | 4 | 4 | 3 | 3 | 4 | 4 | 4 |
| Billing rates (a,b) | | | | | | | | | |
| Onsite | 69.7 | 68.7 | 66.4 | 66.2 | 68.3 | 70.1 | 70.0 | 72.9 | 69.0 |
| Offshore | 23.7 | 23.4 | 22.5 | 22.4 | 23.0 | 23.7 | 23.7 | 22.4 | 21.6 |
| Employee metrics (e) | | | | | | | | | |
| Total employees (consolidated) | 6,598 | 5,924 | 5,622 | 5,296 | 5,041 | 5,006 | 5,137 | 5,304 | 6,031 |
| Billable personnel (%) | | | | | | | | | |
| Onsite (%) | 17.9 | 18.7 | 18.6 | 17.9 | 18.7 | 19.2 | 18.0 | 18.5 | 19.4 |
| Offshore (%) | 69.9 | 68.6 | 68.1 | 69.4 | 68.8 | 68.4 | 70.0 | 69.8 | 70.1 |
| Marketing (incl sales support - %) | 2.1 | 2.3 | 2.3 | 2.2 | 2.5 | 2.6 | 2.5 | 2.5 | 2.3 |
| Others (incl tech support - %) | 10.1 | 10.4 | 11.0 | 10.5 | 10.0 | 9.8 | 9.5 | 9.2 | 8.2 |
| Utilization (a, b) | 63.7 | 65.9 | 73.8 | 72.2 | 74.8 | 75.7 | 75.2 | 69.1 | 68.0 |
| Attrition rate (a, b) | 24.3 | 28.3 | 28.5 | 17.2 | 16.9 | 19.5 | 19.4 | 19.5 | 22.6 |
| DSO | 68 | 67 | 63 | 62 | 57 | 57 | 56 | 62 | 53 |

Notes:

(a) Metrics do not include Focus Frame and Caliber Point

(b) Starting Q12010 includes FocusFrame business

(c) Starting Q12010 includes Caliber Point and FocusFrame businessesMetrics exclude headcount of Caliber Point

(d) Computed on trailing 12 months

(e) Excludes headcount of Caliber Point

(f) Reclassified from June 2010

Source: Company, Kotak Institutional Equities

JULY 29, 2010

CHANGE IN RECO.

Coverage view: **Cautious**

Price (Rs): **622**

Target price (Rs): **625**

BSE-30: **17,992**

Solid execution but without valuation support. We like Jindal Steel and Power's (JSP) strong execution, ability to spot the right opportunities, aggressive project pipeline, impressive return ratios and strong discipline on cash utilization and balance sheet strength. We raise our target price to Rs625 on the increase in our earnings estimates for the steel business and roll forward of target price to March 2012 financials. We still find stock valuations expensive, even as we upgrade our rating to REDUCE from SELL.

Company data and valuation summary

Jindal Steel and Power

Stock data

| | |
|-------------------------------|---------|
| 52-week range (Rs) (high,low) | 786-443 |
| Market Cap. (Rs bn) | 577.0 |

Shareholding pattern (%)

| | |
|-----------|------|
| Promoters | 58.6 |
| FIs | 23.5 |
| MFs | 2.6 |

Price performance (%)

| | 1M | 3M | 12M |
|----------------|-------|--------|------|
| Absolute | 0.1 | (16.4) | 19.6 |
| Rel. to BSE-30 | (2.5) | (18.6) | 0.9 |

Forecasts/Valuations

| | 2010 | 2011E | 2012E |
|---------------------|-------|-------|-------|
| EPS (Rs) | 38.4 | 50.9 | 56.0 |
| EPS growth (%) | 17.3 | 32.7 | 9.9 |
| P/E (X) | 16.2 | 12.2 | 11.1 |
| Sales (Rs bn) | 110.9 | 141.7 | 154.6 |
| Net profits (Rs bn) | 35.7 | 47.4 | 52.1 |
| EBITDA (Rs bn) | 58.5 | 75.6 | 82.0 |
| EV/EBITDA (X) | 11.3 | 8.1 | 6.7 |
| ROE (%) | 37.8 | 34.9 | 28.0 |
| Div. Yield (%) | 0.2 | 0.4 | 0.4 |

Valuations expensive even after 16% correction in stock price in the past three months

We upgrade our rating to REDUCE from SELL earlier after a 16% correction in the stock price in the past 3-months. However, expensive valuations and non-sustainability of merchant power tariffs prevent us from taking a more constructive view on the stock. We have raised our target price to Rs625 (from Rs575 earlier) on (1) roll forward of our estimates to March 2012 financials and (2) increase in our standalone EBITDA estimates. We value the steel business at Rs265, based on 6.5X FY2012E EBITDA. We do not value assign any value to new steel projects; instead we (1) assume continuity of pellet sales beyond what will be captive requirement based on existing steel capacity and (2) value 810MW captive power plant in Orissa and 540 MW power plant in Chattisgarh entirely on merchant power sales. We assume that the acquisition of Shadeed Iron and Steel Company is value neutral noting limited information on likely product sale and production ramp-up.

We revise our valuation for power business to Rs361/share (Rs335 bn) as we roll forward to March 12 based SOTP. Our valuation comprises of (1) Rs183/share (Rs170 bn) for the 1,000 MW merchant power plant (Tamnar I), (2) Rs87/share (Rs81 bn) as value enhancement from the proposed 2,400 MW merchant power plant at Raigarh and (3) Rs91/share (Rs84 bn) for the 1,350 MW captive power plant being built in Angul and Raigarh

Earnings estimates raised for standalone business, lowered for Jindal Power

Our consolidated EPS increases to Rs50.9 and Rs56 for FY2011E and FY2012E from Rs48.7 and Rs50.8 earlier, on account of (1) inclusion of captive power plant estimates (Orissa and Chattisgarh) in the consolidated financials; note that we had already included value of these projects in our SOTP earlier; and (2) increase in iron ore pellet sales assumption. We have raised steel business EBITDA by 27% to Rs40.1 bn for FY2011E and 25.8% to Rs40.8 bn earlier. We have revised our EPS estimates of Jindal power to Rs23/share (previously Rs27/share) in FY2011E and Rs25/share in FY2012E (previously Rs28/share) as we reduce our near-term realization assumption from Rs5.5/kwh to Rs5.0/kw. Our valuation implies a P/E of 12.2X FY2011E EPS and 11.1X on FY2012E EPS.

Kawaljeet Saluja
kawaljeet.saluja@kotak.com
Mumbai: +91-22-6634-1243

Murtuza Arsiwalla
murtuza.arsiwalla@kotak.com
Mumbai: +91-22-6634-1125

Karan Durante
karan.durante@kotak.com
Mumbai: +91-22-6634-1527

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Exhibit 1 provides key changes to our estimates and exhibit 2 provides SOTP valuation for JSP.

Exhibit 1: Jindal Steel and Power (consolidated), Change in estimates, March fiscal year-ends, 2011-12E (Rs mn)

| | Revised estimates | | Old estimates | | % change | |
|-----------------|-------------------|-------------|---------------|-------------|------------|-------------|
| | 2011E | 2012E | 2011E | 2012E | 2011E | 2012E |
| Earnings | | | | | | |
| Net sales | 141,671 | 154,590 | 131,938 | 135,641 | 7.4 | 14.0 |
| EBITDA | 75,565 | 82,009 | 68,083 | 68,036 | 11.0 | 20.5 |
| Adj. PAT | 47,422 | 52,126 | 45,159 | 47,096 | 5.0 | 10.7 |
| EPS (Rs) | 50.9 | 56.0 | 48.7 | 50.8 | 4.6 | 10.3 |

Source: Kotak Institutional Equities estimates

Jindal Steel and Power, SOTP-based valuation, March 2012E (Rs mn)

| | EBITDA | Multiple | Enterprise value | |
|---|---------------|------------|------------------|------------|
| | (Rs mn) | (X) | (Rs mn) | (Rs/share) |
| Steel business | | | 246,864 | 265 |
| Steel business (extant business) | 40,812 | 6.5 | 265,280 | 285 |
| Less: Net debt of steel business | | | 18,416 | 20 |
| Power business | | | 336,176 | 361 |
| Jindal Power (100% subsidiary) -1000 MW | | | | 183 |
| Incremental 2,400 MW | | | | 87 |
| Sale of surplus power from 1,350 MW under construction at Raigarh and Angul | | | | 91 |
| Arrived market capitalization | | | | 626 |
| Target price (Rs/share) | | | | 625 |

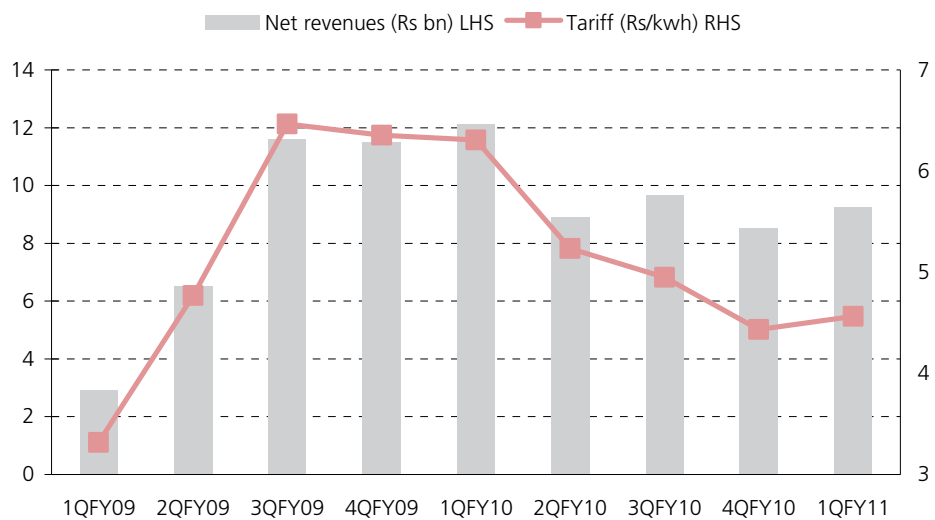
Source: Kotak Institutional Equities estimates

Short term realizations weak-down 27% yoy

JSP's subsidiary Jindal Power (JPL) reported 1QFY11 net sales at Rs9.3 bn and PAT of Rs5.6 bn on generation of 2,210 MU. The implied realizations (assuming 8% AuX) dropped sharply from Rs6.3/kwh in 1QFY10 to Rs4.6/kwh in 1QFY11 (-27.6% yoy). The realizations showed only a marginal sequential improvement despite the onset of the summer months when short-term tariffs are relatively higher and demand at its peak as reflected in JPL's PLF at 101%. We note that tariffs in the bilateral market have improved by 17% sequentially and stood at Rs5.7/kwh and Rs6.2/kwh for the months of April and May, respectively.

Average realizations dropped by 27% yoy

Net revenues and average realizations of JPL, 1QFY09-1QFY11 (Rs bn, Rs/kwh)



Source: Kotak Institutional Equities estimates, Company

Update on Tamnar 2400MW power plant and new projects

We note that the Ministry of Environment and Forest (MOEF) had recently stopped the construction of JSPL's 2400 MW power plant at Tamnar II being implemented through Jindal Power Ltd. The project was awaiting environmental clearances from the MOEF which in March 2009 had asked for a detailed EIA study to be undertaken. However, construction was started without obtaining the requisite environmental clearance—in violation of the provisions of the Environmental Impact Assessment Notification, 2006. The management has indicated that all the environmental studies have been completed and have approached the ministry in this regard. Lack of further traction on Tamnar II is a key risk to our valuation as Tamnar II currently contributes Rs90/share to our SOTP of power business. Progress on the other two projects—Dumka (1,320 MW) and Godda (660 MW) has been limited so far, though JPL has invited tenders for awarding EPC contracts and is in the process of obtaining the requisite approvals to begin execution of the projects. JPL has a pipeline of hydro capacities aggregating 6,100 MW that will likely be commissioned by FY2018-20E.

Update on Shadeed Iron and Steel Company acquisition

JSP had recently acquired Shadeed, a company based in Oman for US\$464 mn. Shadeed is setting up a 1.5 mtpa gas based DRI plant in Oman. JSP indicates that the project will commence commercial operations from 1QFY12. JSP estimates total project cost of US\$525 for this expansion, which will be funded through US\$425 mn of debt and US\$100 mn of equity.

On raw material sourcing, especially iron ore, JSP has kept its options open. While it may primarily source iron ore from Vale or other miners, it is not averse to sending pellets from its Orissa plant to Oman in case external economics are not favorable. The company did not indicate likely product slate from this plant. JSP indicated that it entered into a firm agreement for gas supply at US\$1/ mn BTU. We assume this acquisition to be value neutral.

Key highlights from 1QFY11 earnings call

- ▶ JSP realized Rs760 mn from 110K tons of iron pellet sales. Realization per ton was an impressive Rs6,900, noting that cost of production of will not be more than Rs1,500/ ton.
- ▶ JSP realized Rs1,750 mn from 300K tons of iron ore exports, realizing Rs5,833/ ton.
- ▶ Steel sales were impacted by logistics constraints. The company indicated the unavailability of rakes as a reason for inventory build up, JSP expects inventory liquidation over the next two quarters. JSP reiterated its guidance of 2.5 m of finished steel production in FY2011.
- ▶ The company expects 2.7 mn of pellet production in FY2011, of which 2mn tpa will be consumed internally. JSP expects to operate pellet plant at full capacity in FY2012E.
- ▶ Mining of iron ore is underway at its Bolivian mines which should ramp up in the next few years. JSP confirmed that no compensation is payable to the Bolivian government in the foreseeable future. Exporting the mined iron ore all the way from Bolivia would entail high transportation costs; hence, the company believes it would be more economical to produce sponge and export the same. Natural gas in Bolivia is available at very low rates, further reducing the cost of production.

Jindal Steel & Power (consolidated), Profit model, balance sheet and cash flow model, March fiscal year-ends, 2008-2013E (Rs mn)

| | 2008 | 2009 | 2010E | 2011E | 2012E | 2013E |
|---|----------------|----------------|----------------|----------------|----------------|----------------|
| Profit model (Rs mn) | | | | | | |
| Net sales | 54,890 | 108,510 | 110,915 | 141,671 | 154,590 | 166,288 |
| EBITDA | 22,032 | 51,695 | 58,477 | 75,565 | 82,009 | 83,981 |
| Other income | 498 | 624 | 603 | 3,586 | 4,888 | 5,992 |
| Interest | (2,545) | (4,567) | (3,576) | (6,620) | (5,991) | (8,833) |
| Depreciation | (4,793) | (9,641) | (9,970) | (11,027) | (13,606) | (14,173) |
| Profit before tax | 15,193 | 38,111 | 45,535 | 61,504 | 67,300 | 66,967 |
| Taxes | (2,681) | (8,040) | (9,189) | (13,021) | (14,068) | (13,620) |
| Net profit | 12,512 | 30,072 | 36,346 | 48,483 | 53,232 | 53,347 |
| Share in profit/(loss) of associates | 225 | 396 | 139 | 139 | 139 | 139 |
| Minority interest | 4 | (10) | (755) | (1,200) | (1,244) | (1,356) |
| Profit after tax and minority interest | 12,740 | 30,457 | 35,730 | 47,422 | 52,126 | 52,130 |
| Earnings per share (Rs) | 13.7 | 32.8 | 38.4 | 50.9 | 56.0 | 56.0 |
| Balance sheet (Rs mn) | | | | | | |
| Equity | 38,558 | 70,515 | 104,168 | 150,925 | 200,734 | 251,902 |
| Deferred tax liability | 4,947 | 7,170 | 8,455 | 10,372 | 12,616 | 14,670 |
| Total Borrowings | 69,961 | 81,133 | 86,043 | 101,333 | 73,583 | 44,213 |
| Current liabilities | 19,584 | 34,194 | 50,900 | 42,411 | 43,655 | 43,940 |
| Minority interest | 62 | 45 | 1,659 | 2,859 | 4,103 | 4,103 |
| Total liabilities | 133,112 | 193,057 | 251,224 | 307,900 | 334,691 | 358,827 |
| Net fixed assets | 94,637 | 126,863 | 178,444 | 174,185 | 166,278 | 154,525 |
| Goodwill | 247 | 363 | 1,007 | 1,007 | 1,007 | 1,007 |
| Investments | 2,709 | 5,139 | 3,185 | 1,671 | 1,671 | 1,671 |
| Cash | 6,207 | 6,694 | 1,128 | 69,277 | 102,799 | 138,412 |
| Other current assets | 28,344 | 53,967 | 67,383 | 61,730 | 62,905 | 63,182 |
| Miscellaneous expenditure | 969 | 31 | 78 | 30 | 30 | 30 |
| Total assets | 133,112 | 193,057 | 251,224 | 307,900 | 334,691 | 358,827 |
| Free cash flow (Rs mn) | | | | | | |
| Operating cash flow excl. working capital | 21,095 | 47,939 | 51,737 | 61,838 | 69,083 | 69,573 |
| Working capital changes | (5,137) | (9,152) | 4,010 | (2,836) | 69 | 9 |
| Capital expenditure | (20,371) | (37,176) | (62,419) | (4,900) | (5,700) | (2,420) |
| Free cash flow | (4,413) | 1,611 | (6,672) | 54,102 | 63,452 | 67,162 |
| Ratios | | | | | | |
| Debt/equity | 1.7 | 1.1 | 0.8 | 0.7 | 0.4 | 0.2 |
| Net debt/equity | 1.4 | 0.9 | 0.7 | 0.2 | (0.1) | (0.4) |
| RoAE (%) | 35.4 | 50.9 | 37.8 | 34.9 | 28.0 | 21.8 |
| RoACE (%) | 15.1 | 25.2 | 21.6 | 22.7 | 20.5 | 19.6 |

Source: Company, Kotak Institutional Equities estimates

June 2010: Earnings announcement calendar

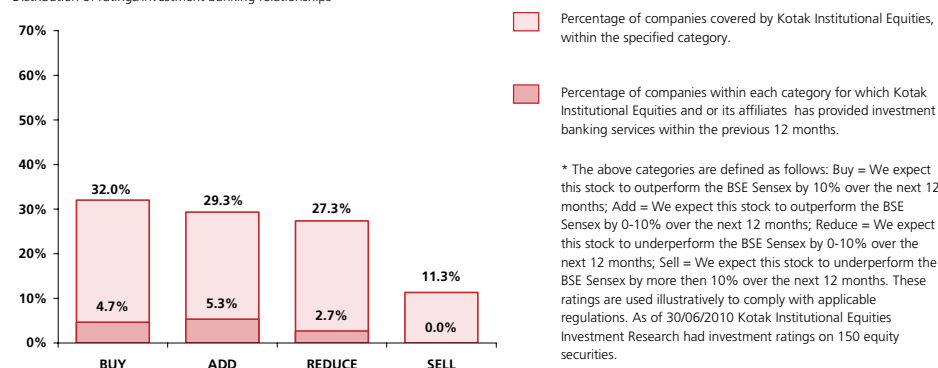
| Mon | Tue | Wed | Thu | Fri | Sat |
|--------------------------|-------------------------|-------------------|---------------------------|-----------------------------------|----------------------|
| 26-Jul | 27-Jul | 28-Jul | 29-Jul | 30-Jul | 31-Jul |
| | | | | ABB | Bank of India |
| | | | | Aditya Birla Nuvo | Bhushan Steel |
| | | | | Ajmera Realty | City Union Bank |
| | | | | BGR Energy | EIH |
| | | | | Bharat Electronics | Grasim Industries |
| | | | | BPCL | GVK Power & Infra |
| | | | | DB Corp | ICICI Bank |
| | | | | Edelwiess Cap | Indian Overseas Bank |
| | | | | Hindustan Construction | J&K Bank |
| | | | | Indian Hotels | Jagran Prakashan |
| | | | | Indian Infoline | JK Cement |
| | | | | Kansai Nerolac | Kolte Patil |
| | | | | Karnataka Bank | Sadbhav Engineering |
| | | | | KEC International | Syndicate Bank |
| | | | | Max India | Torrent Power |
| | | | | NMDC | |
| | | | | PSL | |
| | | | | REI Agro | |
| | | | | Reliance Infra | |
| | | | | Reliance Natural Resources | |
| | | | | Reliance Power | |
| | | | | Religare Enterprises | |
| | | | | Shipping Corp | |
| | | | | Tata Chemicals | |
| | | | | Torrent Power | |
| | | | | TV Eighteen | |
| 2-Aug | 3-Aug | 4-Aug | 5-Aug | 6-Aug | 7-Aug |
| GAIL | Hindalco Industries | Adani Power | Oracle Financial Services | Power Grid Corp | GMR Infra |
| Glaxosmithkline Consumer | Punj Lloyd | IDFC | | Rashtriya Chemicals & Fertilisers | Sterling Biotech |
| India Cements | | Mundra Port & SEZ | | Fortus Healthcare | |
| Madras Cement | | | | | |
| Nestle India | | | | | |
| NMDC | | | | | |
| 9-Aug | 10-Aug | 11-Aug | 12-Aug | 13-Aug | 14-Aug |
| | Adani Enterprises | Bharti Airtel | Apollo Hospitals | | Lanco Infratech |
| | IVRCL Infra | | Cummins India | | |
| | Nagarjuna Constructions | | Hindustan Copper | | |
| | | | Ranbaxy Laboratories | | |
| | | | Tata Power | | |

Source: BSE, Kotak Institutional Equities

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of June 30, 2010

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BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

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Corporate Office

Kotak Securities Ltd.
Bakhtawar, 1st Floor
229, Nariman Point
Mumbai 400 021, India
Tel: +91-22-6634-1100

Overseas Offices

Kotak Mahindra (UK) Ltd
6th Floor, Portsoken House
155-157 The Minories
London EC 3N 1 LS
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc
50 Main Street, Suite No.310
Westchester Financial Centre
White Plains, New York 10606
Tel:+1-914-997-6120

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